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SEC PROPOSES AMENDMENTS REGARDING RULE 10b5-1 PLANS AND RELATED DISCLOSURES

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On December 15, 2021, the U.S. Securities and Exchange Commission (the "SEC") proposed amendments to the affirmative defense in Rule 10b5-1(c) under the Securities Exchange Act of 1934, as amended (the "Exchange Act"), and proposed a number of changes to disclosure requirements applicable to issuers and insiders.[1] The SEC described the proposed amendments as intended to address "critical gaps in the SEC's insider trading regime and to help shareholders understand when and how insiders are trading in securities for which they may at times have material nonpublic information."

If adopted after a 45-day comment period, these proposed amendments would:

- Update the requirements for the affirmative defense, including: imposing a cooling-off period before trading could commence under a plan; prohibiting overlapping trading plans; and limiting single-trade plans to one trading plan per 12-month period.
- Require directors and officers to furnish written certifications to the issuer that they are not aware of any material nonpublic information when they enter into trading plans.
- Expand the existing good faith requirement to require that Rule 10b5-1 plans *operate* in good faith.
- Require issuers to disclose in quarterly and annual filings: their policies and procedures related to insider trading; and their practices around the timing of option grants and the release of material nonpublic information.
- Require insiders to disclose the use of Rule 10b5-1 plans in Forms 4 and 5.
- Require that *bona fide* gifts of securities, which are currently permitted to be reported by insiders on Form 5, be reported more quickly on Form 4.

Background

Adopted over 20 years ago, Rule 10b5-1 provides an affirmative defense against allegations of insider trading by companies and their insiders engaging in transactions in the company's stock,

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even while in possession of material nonpublic information at the time of trading, through plans that are set up in advance. Over the years, academic studies have suggested that insiders with Rule 10b5-1 plans may achieve better returns than those not trading pursuant to Rule 10b5-1 plans. Those studies, as well as situations where insiders appeared to conduct questionable transactions under Rule 10b5-1 plans, have created negative perceptions about the use of Rule 10b5-1 plans by issuers and insiders.

In 2007, Linda Chatman Thomsen, then the Director of the SEC's Division of Enforcement, delivered a speech highlighting concerns about the use of Rule 10b5-1 plans.[2] At the time, she said that the SEC would probe issues associated with the use of Rule 10b5-1 trading plans by insiders, and those warnings by the SEC Staff continued for a few years after that speech. Citing academic studies, Thomsen noted that executives who trade within a Rule 10b5-1 plan outperformed their peers who trade outside such a plan. In response, she noted that "[w]e and others are looking at the disclosures surrounding 10b5-1 plans. We're looking at multiple and seemingly overlapping 10b5-1 plans and at asymmetrical disclosure around plans—that is, disclosure of entry into a 10b5-1 plan, without timely disclosure of related plan modifications or terminations."

In 2013, the Council of Institutional Investors (the "CII") submitted a rulemaking petition to the SEC, expressing concerns about Rule 10b5-1 plans.[3] The CII requested that the SEC consider issuing interpretive guidance or adopting amendments to Rule 10b5-1 that would require Rule 10b5-1 plans to be adopted with the additional protocols or guidelines that the CII believed would curb the potential for abuse of Rule 10b5-1 trading plans.

Following recent legislative efforts to compel the SEC to act on Rule 10b5-1 plans, in June 2021 SEC Chair Gary Gensler said that Rule 10b5-1 plans had led to "real cracks in our insider trading regime" and announced that he had asked the SEC Staff to provide recommendations on how the SEC might "freshen up" Rule 10b5-1. Gensler indicated that the Staff would look into possible reforms to Rule 10b5-1. Gensler's comments were followed by recommendations to amend Rule 10b5-1 from the SEC's Investor Advisory Committee.[4]

In the Proposing Release, the SEC states:

> We share the concern about the prevalence of trading practices by corporate insiders and issuers that suggest the misuse of material nonpublic information. We also understand that some issuers have engaged in a practice of granting stock options and other equity awards with option-like features to executive officers and directors in coordination with the release of material nonpublic information. In addition, there is research indicating that some corporate insiders may be opportunistically timing gifts of securities while aware of material nonpublic information relating to such securities. These practices can undermine the public's confidence and

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expectations of honest and fair capital markets by creating the appearance that some insiders, by virtue of their positions, do not play by the same rules as everyone else.

Proposed Amendments to Rule 10b5-1

Rule 10b5-1(c)(1) establishes an affirmative defense to Rule 10b-5 liability for a trade if the trade was made pursuant to a binding contract, an instruction to another person to execute the trade for the instructing person's account, or a written plan. A person asserting a Rule 10b5-1(c)(1) defense must satisfy several conditions:

- The person must demonstrate that, before becoming aware of material nonpublic information, they had entered into a binding contract to purchase or sell the security, provided instructions to another person to execute the trade for the instructing person's account, or adopted a written plan for trading the securities;
- The person must demonstrate that the applicable contract, instructions, or plan: (i) specified the amount of securities to be purchased or sold, price, and date; (ii) provided a written formula or algorithm, or computer program, for determining amounts, prices, and dates; or (iii) did not permit the person to exercise any subsequent influence over how, when, or whether to effect purchases or sales; provided, in addition, that any other person who exercised such influence was not aware of the material nonpublic information when doing so; and
- The person must demonstrate that the purchase or sale was pursuant to the prior contract, instruction, or plan.

Rule 10b5-1(c)(1) states that a purchase or sale is not pursuant to a contract, instruction, or plan if, among other things, the person who entered into the arrangement altered or deviated from the contract, instruction, or plan, or entered into or altered a corresponding or hedging transaction or position with respect to the securities. The rule also provides that the affirmative defense of a trading arrangement is only available if the trading arrangement was entered into "in good faith and not as part of a plan or scheme to evade the prohibitions" of the rule.

Cooling-Off Period

Currently, Rule 10b5-1(c)(1) does not impose any waiting period between the date on which the trading arrangement is adopted and the date of the first transaction to be executed under the trading arrangement, although in practice many insiders include a waiting period in their Rule 10b5-1 plans. Rule 10b5-1 plan guidelines that issuers adopt as part of their insider trading prevention programs often require waiting periods, although the term of the waiting period that is prescribed varies.

The SEC proposes to amend Rule 10b5-1(c)(1) to add as a condition to the availability of the affirmative defense:

- A minimum 120-day cooling-off period after the date of adoption of any Rule 10b5-1(c)(1) trading arrangement (including adoption of a modified trading arrangement) by a director or officer (as defined in Exchange Act Rule 16a-1(f)) before any purchases or sales under the new or modified trading arrangement; and
- A minimum 30-day cooling-off period after the date of adoption of any Rule 10b5-1(c)(1) trading arrangement by an issuer before any purchases or sales under the new or modified trading arrangement.

Under the proposed amendments, for directors and officers subject to Exchange Act Section 16 reporting, and for issuers, the Rule 10b5-1(c)(1) affirmative defense would only be available for a trading arrangement that includes a cooling-off period that delays transactions under the trading arrangement for at least 120 or 30 days (whichever is applicable) after the date of adoption of any new or modified trading arrangement. The proposed amendments also include a note clarifying that a "modification" of an existing Rule 10b5-1(c)(1) trading arrangement, including cancelling one or more trades, would be deemed equivalent to terminating the plan in its entirety, and the cooling-off period would therefore apply after a "modification" before any new trades could commence.

The SEC notes in the Proposing Release that applying a cooling-off period to directors and officers is appropriate "because such individuals are more likely than others to be aware of material nonpublic information in the general

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