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A Frosty Proposal From the SEC on 10b5-1 Plans and Related Disclosures

December 22, 2021

On December 15, 2021, the Securities and Exchange Commission announced that it proposed amendments that would impose new conditions on the availability of the Rule 10b5-1 affirmative defense, as well as new disclosure and reporting obligations on issuers, directors and officers regarding adoption, modification and termination of Rule 10b5-1 trading plans, issuer insider trading policies and procedures, the timing of certain awards of stock options, stock appreciation rights (SARs) or similar instruments, and bona fide gifts. According to the proposing release, the SEC expects these amendments "to provide greater transparency to investors (*i.e.*, decrease information asymmetries between insiders and outside investors) about issuer and insider trading arrangements and restrictions, as well as insider compensation and incentives, enabling more informed decisions about investment in the company."

The SEC is soliciting comments on questions relating to the proposed amendments. The comment period will be open for 45 days after the proposing release is published in the Federal Register.

Background

Section 10(b) of the Securities Exchange Act of 1934 (Exchange Act) and Rule 10b-5 thereunder prohibit, among other things, the purchase or sale of securities of an issuer on the basis of material nonpublic information about that security or issuer. Corporate insiders, or executive officers and directors of an issuer, typically receive a meaningful portion of their overall compensation in the form of equity awards. However, liquidating those equity awards can be difficult because corporate insiders are often in possession of material nonpublic information, which puts them at risk of insider trading or at least claims of insider trading. To address this issue, in 2000, the SEC adopted Rule 10b5-1, which provides an affirmative defense to Rule 10b-5 liability for trades 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.

The affirmative defense does not eliminate or operate as a safe harbor from liability; rather, to assert the affirmative defense, and prove that the purchase or sale was not made "on the basis" of material nonpublic information, the person must demonstrate that:

- Before becoming aware of the material nonpublic information, the person had entered into a binding contract to purchase or sell the security, instructed another person to purchase or sell the security for the instructing person's account, or adopted a written plan for trading securities.
- The contract, instruction or plan (1) specified the amount of securities to be purchased or sold, and the price at which and the date on which the securities were to be purchased or sold; (2) included a written formula or algorithm, or computer program, for determining the amount of securities to be purchased or sold, and the price at which and the date on which the securities were to be purchased or sold; or (3) did not permit the person to exercise any subsequent influence over how, when or whether to effect purchases or sales, provided that any other person who did exercise such influence was not aware of the material nonpublic information when doing so.
- The purchase or sale was made pursuant to the contract, instruction or plan, and the person did not enter into or alter a corresponding or hedging transaction or position with respect to those securities.
- The contract, instruction or plan was given or entered into in good faith, and not as part of a plan or scheme to evade the prohibitions of the rule.

Aside from the foregoing requirements, Rule 10b5-1 currently does not include any other prescriptive requirements for 10b5-1 plans[2] – there is no required cooling-off period, no limit on the number of modifications, no limit on terminations or on overlapping plans, and no disclosure requirements other than the requirement for affiliates to provide the date of plan adoption when filing a notice of proposed sale on Form 144 – although one

or more of these requirements or limitations often are adopted as part of an issuer's insider trading policies or 10b5-1 plan guidelines. This perceived lack of guardrails, combined with the absence of public information requirements, has long fueled concerns about 10b5-1 plans and potential abuses of the affirmative defense under Rule 10b5-1. Accordingly, the SEC is proposing these amendments "to address concerns about abuse of the rule" as well as "critical gaps in the SEC's insider trading regimes and to help shareholders understand when and how insiders are trading in securities for which they may at times have material nonpublic information."

Proposed amendments to Rule 10b5-1

The SEC has proposed five new conditions to the availability of the affirmative defense provided in Rule 10b5-1(c)(1).

1. Cooling-off periods

A "cooling-off" period is the time between the adoption (or modification) of the 10b5-1 plan and when the first trade under the 10b5-1 plan may occur. While not required under the current rules, many companies (and most brokerage firms that administer 10b5-1 plans on behalf of companies and individuals) impose mandatory cooling-off periods as part of their plan guidelines for officers and directors. Those cooling-off periods generally range from a minimum of 30 calendar days to the start of the next open trading window.

The SEC has proposed a mandatory 120-day cooling-off period for 10b5-1 plans entered into (or modified) by Section 16 officers and directors, and a mandatory 30-day cooling-off period for 10b5-1 plans entered into (or modified) by issuers.[3] Consistent with existing guidance, the proposing release notes that any "modification" of an existing 10b5-1 plan, including the cancellation of one or more trades, would be treated as a termination of the plan in its entirety and adoption of a new plan.

In the proposing release, the SEC stated that the 120-day cooling-off period would apply to Section 16 officers and directors, rather than other traders relying on the Rule 10b5-1(c)(1) affirmative defense, "because such individuals are more likely than others to be aware of material nonpublic information in the general course of events, and also more likely to be involved in making or overseeing key corporate decisions that have the potential to affect the issuer's stock price, including decisions about the timing of the disclosure of such information." Similarly, the 30-day cooling-off period for issuers is meant to address concerns that issuers may buy back stock when in possession of material nonpublic information and "to boost the price of the issuer's stock before sales by corporate insiders." In addition to the 30-day cooling off period, the SEC has separately proposed amendments to update the disclosure requirements for issuer repurchase programs.[4]

Although the release observes that the time periods selected "align with recommendations from a wide range of commentators," if adopted, the 120-day cooling-off period would be markedly longer than current issuer- and brokerage firm-imposed cooling-off periods for directors, officers and other employees entering into or modifying 10b5-1 plans. Coupled with the fact that some companies limit adoption or modification of 10b5-1 plans to open trading windows, this new mandatory cooling-off period would significantly impact the availability of the Rule 10b5-1 affirmative defense for corporate insiders desiring to liquidate and diversify their holdings. In addition, the 30-day cooling-off period for issuers would also be much longer than current practice, with many companies undertaking stock buybacks with no cooling-off period. In its request for comment, the SEC asked whether the proposed durations for cooling-off periods are appropriate and whether the 120-day cooling-off period should be limited to Section 16 officers and directors, as proposed, or expanded to apply to other corporate insiders, including other officers and employees, or all traders.

2. Director and officer certifications

Under the proposed amendments, Section 16 officers and directors would be required to furnish to the issuer a written certification at the time of the adoption or modification of a 10b5-1 plan. A certification would not be required if an existing 10b5-1 plan is terminated without the adoption of a new or modified plan. The certification would be required to state that (a) the officer or director is not aware of material nonpublic information about the issuer or its securities and (b) the officer or director is adopting the 10b5-1 plan in good faith and not as part of a plan or scheme to evade the prohibitions of Section 10(b) under the Exchange Act or Rule 10b-5.

In addition, the officer or director would be required to retain a copy of this certification for 10 years, which is consistent with the statutes of limitation that govern the SEC's ability to seek certain remedies for insider trading

claims. In the proposing release, the SEC states that this certification would not be required to be filed with the SEC and "would not be an independent basis of liability for directors or officers under Exchange Act Section 10(b) and Rule 10b-5." It would, however, "underscore the certifiers' awareness of their legal obligations under the federal securities law related to the trading in the issuer's securities."

If adopted, these required certifications would be more a codification of existing practice, given that most 10b5-1 plan forms provided by brokerage firms require these and other representations.

3. Restrictions on overlapping plans

Under the proposed amendments, the affirmative defense under Rule 10b5-1 would be unavailable for any trades by a trader who has established multiple overlapping trading arrangements for open market purchases or sales of the same class of securities. This amendment would apply to any trader (including the issuer), not just Section 16 officers and directors.

Under the current rules, the affirmative defense is unavailable if the trader enters into or alters a corresponding or hedging transaction or position with respect to those securities. In the proposing release, the SEC states that it is concerned that the use of multiple overlapping plans could "be used to simulate this kind of impermissible hedging." In addition, the SEC states that it is concerned that "a person could circumvent the proposed cooling-off period by setting up multiple overlapping [10b5-1 plans], and deciding later which trades to execute and which to cancel after they become aware of material nonpublic information but before it is publicly released."

The SEC explicitly noted that this amendment would not apply to shares acquired directly from the issuer, such as through participation in employee stock ownership plans or dividend reinvestment plans.

4. Limitations on single-trade plans

Under the proposed amendments, the availability of the affirmative defense under Rule 10b5-1 would be limited for single-trade plans and would be available for only one single-trade plan during any 12-month period.

5. Requiring that plans be "operated" in good faith

Under current rules, a person entering into a 10b5-1 plan must do so in good faith. The SEC has proposed to extend this good faith requirement beyond entry into the 10b5-1 plan to the operation of the plan. In effect, the SEC states that this means that the affirmative defense would be unavailable "to a trader that cancels or modifies their plan in an effort to evade the prohibitions of the rule or uses their influence to affect the timing of a corporate disclosure to occur before or after a planned trade under a [10b5-1 plan] to make such trade more profitable or to avoid or reduce a loss." This new requirement would apply to any trader, including the issuer, not just Section 16 officers and directors.

Proposed amendments to disclosures

In addition to the amendments to Rule 10b5-1 discussed above, the SEC has proposed new disclosure obligations applicable to issuers and corporate insiders.

Disclosures regarding 10b5-1 plans and insider trading

The SEC proposed new Item 408 of Regulation S-K, with corresponding amendments to Forms 10-K, 10-Q and 20-F, and Schedules 14A and C. The disclosures made under new Item 408 would be subject to the officer certifications required by Section 302 of the Sarbanes-Oxley Act of 2002.

Quarterly reporting of trading plans

Under Item 408(a) of Regulation S-K, for each completed fiscal quarter, the registrant would be required to disclose in its Form 10-Q and Form 10-K (for its fourth quarter) whether the registrant or any Section 16 officer or director has adopted or terminated any contract, instruction or written plan to purchase or sell its securities, whether or not intended to satisfy the Rule 10b5-1 affirmative defense. As discussed above, any modification or amendment to the contract, instruction or written plan would be deemed to be a termination of the existing arrangement and adoption of a new arrangement and, accordingly, a description of such modification or

amendment would be required.

If the registrant or a Section 16 officer or director has adopted or terminated a contract, instruction or written plan (regardless of whether it is intended to satisfy the Rule 10b5-1 affirmative defense) during the recently completed quarter, then the registrant would be required to provide a description of the material terms, including the following:

- The date of adoption or termination.
- The duration of the contract, instruction or written plan.
- The aggregate amount of securities to be sold or purchased pursuant to the contract, instruction or written plan.

For officers and directors, the registrant would also be required to also provide their names and titles.

New Item 408(a) would be added to Part II, Item 5, "Other Information," of Form 10-Q, and Part III, Item 10, "Directors, Executive Officers and Corporate Governance," of Form 10-K. These new disclosure requirements would not apply to foreign private issuers (FPIs) that file Form 20-F because they are not required to file quarterly reports on Form 10-Q; however, the new insider trading disclosures discussed below would apply to FPIs.

Annual reporting of insider trading policies and practices

Under Item 408(b) of Regulation S-K, the registrant would be required to disclose in its Form 10-K and proxy or information statement, or Form 20-F, as applicable, whether it has adopted insider trading policies and procedures governing the purchase, sale, and other dispositions of its securities by directors, officers and employees, or by the registrant itself, that are reasonably designed to promote compliance with insider trading laws, rules and regulations, and any applicable listing standards.

If the registrant has not adopted these policies and procedures, then it would be required to explain why it has not done so. If the registrant has adopted these policies and procedures, then it would be required to disclose them. In terms of what would be required to be disclosed, the proposing release states that "registrants should endeavor to provide detailed and meaningful information from which investors can assess the sufficiency of the insider trading policies and procedures." This may include, among other things, "information on the issuer's process for analyzing whether directors, officers, employees or the issuer itself when conducting an open-market share repurchase have material nonpublic information; the issuer's process for documenting such analyses and approving requests to purchase or sell its securities; or how the issuer enforces compliance with any such policies and procedures it may have." Thus, at a minimum, registrants would need to describe any pre-clearance procedures in place for sales by directors, officers and employees, as well as any consequences for failure to comply with the registrant's insider trading policies and procedures.

Of note, while the proposing release likens this disclosure requirement to Item 406 of Regulation S-K, relating to the registrant's code of ethics and requiring the registrant to file the code of ethics with the SEC or post it to the registrant's corporate website, there is no requirement under the proposed rules to file the registrant's insider trading policy as an exhibit to any SEC filing or to post it on the registrant's website.

New Item 408(b) would be added to Part III, Item 10, "Directors, Executive Officers and Corporate Governance," of Form 10-K, Item 7 of Schedule 14A, and Item 16J of Form 20-F, and would be applicable to both domestic registrants and FPIs.

Section 16 reports

In December 2020, the SEC proposed rules that would, among other things, add a checkbox to Forms 4 and 5 allowing Section 16 filers to report, on a voluntary basis, whether the transaction was made under a 10b5-1 plan.[5] The SEC is now proposing to make this disclosure mandatory and expand this disclosure to require the date of adoption of the 10b5-1 plan.

Many Section 16 filers already include footnote disclosure in the applicable Form 4 or 5 filing that indicates when a transaction was made pursuant to a 10b5-1 plan, although practice varies widely as to whether the date of adoption or any other information is included in that explanatory note.

In addition, the SEC is proposing to add a second, optional checkbox to Forms 4 and 5, which would allow a Section 16 filer to indicate whether the transaction was made pursuant to a pre-planned contract, instruction or written plan that was **not** intended to satisfy Rule 10b5-1.

Disclosures regarding timing of stock option grants

On the heels of the recent publication of Staff Accounting Bulletin No. 120 by the SEC's Office of the Chief Accountant regarding spring-loaded stock option awards, the SEC proposed new narrative and tabular disclosure requirements stemming from its concern that the existing disclosure requirements "do not provide investors with adequate information regarding an issuer's policies and practices on stock option awards timed to precede or follow the release of material nonpublic information." Proposed subsection (x) to Item 402 of Regulation S-K would require enhanced narrative disclosure about the registrant's policies and practices on the timing of grants of stock options[6] in relation to the disclosure of material nonpublic information. This disclosure would need to include:

How the board of directors determines when to grant stock options (e.g., whether awards are granted on a predetermined schedule).

Whether, and if so, how, the board or compensation committee considers material nonpublic information when determining the timing and terms of an award.

Whether the registrant has timed the disclosure of material nonpublic information for the purpose of affecting the value of executive compensation.

In addition, new Item 402(x)(2)(i) would require tabular disclosure of each stock option granted during the last completed fiscal year to any named executive officer (NEO) within 14 calendar days before or after the filing of a periodic report on Form 10-Q or Form 10-K, an issuer share repurchase, or the filing or furnishing of a Form 8-K that contains material nonpublic information (including earnings releases). The information in the table would need to include:

- The name of the NEO.
- The grant date.
- The number of securities underlying the award.
- The exercise price.
- The grant date fair value.
- The market price of the underlying securities on the trading day before the disclosure of the material nonpublic information.
- The market price of the underlying securities on the trading day after the disclosure of the material nonpublic information.

Emerging growth companies and smaller reporting companies would not be exempt from these disclosure requirements.

Bona fide gifts

Under current rules, a bona fide gift made by a Section 16 officer or director is exempt from Section 16(b) by virtue of Rule 16b-5. Accordingly, a bona fide gift may currently be reported on a voluntary basis on Form 4 or on a delayed basis on Form 5 after the issuer's fiscal year-end.

In the proposing release, the SEC stated that this delayed reporting "may allow insiders to engage in problematic practices involving gifts," and has proposed to amend Exchange Act Rule 16a-3 to require the reporting of dispositions of bona fide gifts of equity securities on Form 4. This would mean that Section 16 officers and directors would need to report bona fide gifts within two business days of the transaction.

Observations and commentary

- If adopted in their current form, these proposed rules would be a significant departure from established practice in terms of the operation of and disclosures for 10b5-1 plans. Although the amendments to Rule 10b5-1 are only in the proposed rulemaking stage, and any final rules may differ in some respects, companies should review any existing 10b5-1 plan

guidelines in light of these proposed amendments, including any company-imposed cooling-off periods, and other restrictions and requirements that may align or differ from the proposed rules, and consider what impacts the proposed rules may have on their current practices.

- Companies should review their insider trading policies, in particular regarding trading windows, pre-clearance procedures and any consequences related to noncompliance with such policies. As part of this review, companies may want to begin thinking about how they would disclose and describe their insider trading policies, and whether any amendments may be desirable to strengthen or add clarity to existing provisions. In addition, if the new disclosure obligations regarding insider trading policies and procedures are adopted, then companies may want to consider updates to their sub-certification process to cover these new disclosures, which would be subject to the officer certifications required by Section 302 of the Sarbanes-Oxley Act of 2002.
- In the proposing release, the SEC clarifies that a "sale" under the Exchange Act is not required to be "for value." Accordingly, in the gift context, the SEC states that it would be a violation of Exchange Act Section 10(b) "if the donor gifts a security of an issuer in fraudulent breach of a duty of trust and confidence when the donor was aware of material nonpublic information about the security or issuer, and knew or was reckless that the donee would sell the securities prior to the disclosure of such information." Thus, companies may consider reviewing their insider trading policies and procedures regarding gifts, as many insider trading policies either exempt gifts or are not clear with respect to the treatment of gifts.
- With respect to the proposed disclosure regarding the timing of stock option grants, the SEC is focused on providing shareholders with "a full and complete picture of any spring-loaded or bullet-dodging option grants during the fiscal year." Spring-loading is timing a grant to occur immediately before the release of positive material nonpublic information and bullet-dodging is delaying a planned grant until after the release of material nonpublic information that is likely to decrease the stock price. Given the proposed expanded disclosure requirements and potentially increased scrutiny by investors of option grant timing, companies that grant stock options may want to review existing equity grant policies and practices, and discuss with counsel whether any formal policies or practices should be adopted or revised, particularly those relating to equity grants that may be made during closed trading windows or close in time to earnings announcements or announcements of material events.
- The proposed amendments to Rule 10b5-1 do not provide an exception for "sell to cover" arrangements intended to satisfy tax withholding obligations, and it is unclear how the SEC intends to apply the limitations on overlapping plans in that context. Under the proposed amendments, employees using 10b5-1 arrangements to "sell to cover" shares underlying equity awards to satisfy tax withholding obligations may no longer be able to utilize the affirmative defense in adopting a 10b5-1 plan for the sale of any other securities of the issuer. However, the SEC requested comments on how the overlapping plan restriction might impact tax withholding for equity awards, and we would hope the SEC will address that issue in the final rules by exempting tax withholding transactions from the limitations on overlapping plans, given the same concerns regarding potentially abusive practices do not exist for "sell to cover" transactions that are intended only to satisfy tax withholding obligations.

Notes

1. "Final Rule: Selective Disclosure and Insider Trading," SEC Rel. No. 33-7881 (August 15, 2000).
2. For ease of reference, binding contract, instruction and written plan are collectively referred to as "10b5-1 plan(s)" throughout this alert.
3. Many issuers adopt a 10b5-1 plan when they implement a Rule 10b-18 stock repurchase program to avail themselves of the affirmative defense under Rule 10b5-1.
4. On December 15, the SEC proposed amendments to rules regarding issuer stock repurchases, also referred to as stock buybacks. The proposed rules would require more detailed and more frequent and timely disclosure about issuer share repurchases, including, among other things, requiring a new Form SR for next-day repurchase reporting and amending Item 703 of Reg. S-K to require additional disclosures relating to issuer share repurchase practices, policies and procedures.
5. "Rule 144 Holding Period and Form 144 Filings,"Rel. No. 33-10911 (December 22, 2020).
6. The proposed rule applies to stock options, stock appreciation rights and similar instruments with optionlike features. For ease of reference, such awards are collectively referred to as "stock options" in this alert. The proposed rule does not seem to apply to restricted stock units, restricted stock awards, phantom stock, phantom stock units or any similar instruments that do not have optionlike features.

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