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December 17, 2021

Legal Update

SEC Proposes Amendments to Rule 10b5-1's Affirmative Defense to Insider Trading Liability

On December 15, 2021, the Securities and Exchange Commission (the "SEC") proposed amendments (the "proposal") to Rule 10b5-1 under the Securities Exchange Act of 1934 (the "Exchange Act") and related disclosure obligations for public companies. The proposal would (i) add new conditions to the availability of the affirmative defense to insider trading liability contained in Rule 10b5-1 that are designed to address concerns about abuse of the rule by issuers and insiders to trade securities on the basis of material nonpublic information ("MNPI") and (ii) enhance public disclosure by issuers and insiders of such trading plans. This Legal Alert describes the proposal and discusses some practical considerations.

Background

Section 10(b) of the Exchange Act and Rule 10b-5 promulgated thereunder prohibit purchases or sales of a security on the basis of MNPI about that security or its issuer, in breach of a duty owed to such issuer or the shareholders of such issuer or to any person who is the source of that MNPI. This prohibited conduct is more commonly referred to as "insider trading." Rule 10b5-1 provides an affirmative defense to insider trading liability for trades undertaken pursuant to a binding contract, an instruction to another person to execute the trade for the instructing person's account or a written plan (collectively, a "10b5-1 Plan") adopted when the trader was not aware of MNPI. 10b5-1 Plans must be entered into in good faith and not as part of a scheme to evade the prohibitions of the insider trading rules.

Since its adoption in 2000, the SEC, courts, members of Congress, academics and others have grown increasingly concerned that Rule 10b5-1 has allowed traders to escape liability by trading with MNPI while still technically satisfying the Rule's requirements. To allay these concerns, the SEC is seeking comment on the proposed amendments described below. The proposal is generally consistent with prior statements made by SEC Chair Gensler regarding 10b5-1 Plans, as well as with the recommendations made to the SEC by the Investor Advisory Committee regarding 10b5-1 Plans.[1]

Proposed Amendments to Rule 10b5-1

COOLING-OFF PERIODS FOR DIRECTORS, OFFICERS AND ISSUERS

At present, Rule 10b5-1 does not require any waiting period between the date on which a 10b5-1 Plan is adopted and the date of the first transaction made pursuant to that plan although some plans voluntarily adopt

a cooling-off period. Under the proposal, in order to qualify for the affirmative defense provided by Rule 10b5-1:

- 10b5-1 Plans adopted by a director or officer[2] would be required to include a minimum 120-day cooling-off period between adoption and any purchase or sale made pursuant to the 10b5-1 Plan; and
- 10b5-1 Plans adopted by an issuer would be required to include a minimum 30-day cooling-off period between adoption and any purchase or sale made pursuant to the 10b5-1 Plan.

The proposal solicits comment on a number of issues relating to the cooling-off period, including on the length of the proposed cooling-off periods, whether the proposed cooling-off period should be limited to directors and officers and whether a different period is appropriate for issuers.

The proposal would clarify that a "modification" of an existing 10b5-1 Plan would be deemed to be a termination of such 10b5-1 Plan and restart the applicable cooling-off period. Specifically: any cancellation of one or more trades would constitute a "modification." The proposal does not otherwise define the term "modification" and does not provide any *de minimis* modification exception.

DIRECTOR AND OFFICER CERTIFICATIONS

Under the proposal, at the time a 10b5-1 Plan is adopted (or modified) directors and officers would be required to certify in writing that they: (i) were not aware of MNPI about the issuer or its securities; and (ii) are adopting (or modifying) the 10b5-1 Plan in good faith and not as part of a scheme to evade the prohibitions of the Exchange Act's Section 10(b) or Rule 10b-5. Directors and officers would be required to furnish these written certifications to the issuer "promptly" and personally retain them for a period of ten years.[3] The proposal would not require filing of these certifications with the SEC. The SEC's proposing release (but not the proposed rule itself) states that the "proposed certification would not be an independent basis of liability for directors and officers" under the insider trading rules.

PROHIBITION ON OVERLAPPING 10B5-1 PLANS AND LIMITS ON SINGLE TRADE 10B5-1 PLANS FOR ALL TRADERS

The proposal would eliminate Rule 10b5-1's affirmative defense for trades by *any trader* (*i.e.*, beyond directors, officers and issuers) who has established multiple overlapping 10b5-1 Plans for open market purchases or sales of the same class of securities. Transactions with the issuer, such as employee stock purchase plans ("ESPPs") or dividend reinvestment plans ("DRIPs") would be excluded from this prohibition of overlapping plans.

Additionally, the proposal would limit the availability of the affirmative defense to one "single-trade" 10b5-1 Plan during any 12-month period.

GOOD FAITH OPERATION

As mentioned, Rule 10b5-1 currently requires that 10b5-1 Plans be entered into in good faith and not as part of a plan or scheme to evade the insider trading rules. In order to clarify that cancellations or modifications of a 10b5-1 Plan may not be conducted in a manner to benefit from MNPI, the proposal would amend the Rule to require that 10b5-1 Plans be entered into *and operated* in good faith.

Proposed New Disclosure Requirements for Public Companies and Insiders

PUBLIC COMPANY DISCLOSURES

At present, there are no disclosure requirements concerning the adoption, termination or use of 10b5-1 Plans by issuers or insiders, and issuers are not required to disclose their insider trading policies or procedures. The

proposal would add a new Item 408 to Regulation S-K and amend Forms 10-Q, 10-K and 20-F to require such disclosure. The proposed disclosures would be subject to the Sarbanes-Oxley Act Section 302 certifications.

Under the proposal, public companies reporting using the domestic forms (*e.g.*, Form 10-Q and Form 10-K) would be required to provide quarterly disclosure of the adoption or termination of 10b5-1 Plans and other trading arrangements for the company, and its directors and officers. Disclosures would be required to include material terms of the 10b5-1 Plan or arrangement, such as the date of adoption or termination, the duration of the 10b5-1 Plan or arrangement, the aggregate number of securities to be sold or purchased pursuant to the 10b5-1 Plan or arrangement and whether the arrangement is intended to satisfy the requirements for use of Rule 10b5-1's affirmative defense.

Public companies would also be required to disclose whether they have adopted insider trading policies and procedures reasonably designed to promote compliance with the insider trading laws. If a company has not adopted such policies and procedures, it would be required to disclose why it has not done so. Registrants that use the domestic forms would be required to make these disclosures annually in their annual report on Form 10-K, and foreign private issuers would similarly be required to include this information in their annual Form 20-F filings. The proposing release states:

> [R]egistrants should endeavor to provide detailed and meaningful information from which investors can assess the sufficiency of their insider trading policies and procedures. For example investors may find useful [. . .] 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.

The proposal would also create new obligations for executive compensation disclosure. Specifically, new tabular disclosure would be required to list for each director and named executive officer:

- each option award (including the number of securities underlying the award, the date of grant, the grant date fair value and the option's exercise price) granted within 14 calendar days before or after the filing of a periodic report, an issuer share repurchase or the filing or furnishing of a current report on Form 8-K that contains MNPI; and
- the market prices of the underlying securities the trading days before and after the disclosure of the MNPI.

In addition, to the tabular disclosures, the proposal would require narrative disclosure about the company's option grant policies and practices regarding the timing of option grants and the release of MNPI, including how the board determines when to grant options and whether, and if so, how, the board or compensation committee takes MNPI into account when determining the timing and terms of an award. This disclosure would be required to be included in annual reports on Form 10-K[4] and proxy and information statements related to the election of directors, approval or compensation plans or solicitations of advisory votes to approve executive compensation. Unlike other executive compensation disclosure, emerging growth companies ("EGCs") and smaller reporting companies ("SRCs") would not be exempt from these disclosure requirements.

INSIDER OBLIGATIONS UNDER SECTION 16 OF THE EXCHANGE ACT

Persons reporting transactions on a Form 4 or Form 5 pursuant to Section 16 under the Exchange Act would be required to identify whether the reported transaction was executed pursuant to a 10b5-1 Plan. In addition, such persons could voluntarily indicate that the transaction was made pursuant to a pre-planned contact or instruction that is not intended to satisfy the conditions of Rule 10b5-1.

Relatedly, the proposal would that require *bona fide* gifts of securities, whether as part of a 10b5-1 Plan or not, be reported on a Form 4 by the end of the second business day following the gift. Currently, these transactions are reportable on a Form 5, which is filed once a year within 45 days after the issuer's fiscal year end.

PRACTICAL CONSIDERATIONS

Although the amendments to Rule 10b5-1 are just in the proposal stage, and there may be changes before any final amendments are adopted, the proposal illuminates concerns that the SEC has with 10b5-1 Plans. Companies may want to use the proposal as a framework for an internal analysis of their current Rule 10b5-1 practices. For example, companies not currently requiring cooling-off periods following the adoption or modification of a 10b5-1 Plan by officers or directors may want to consider voluntarily instituting such a requirement, although for now perhaps for a shorter period than the 120 days proposed by the SEC. Companies that already require a cooling-off period might assess whether the length is appropriate. Similarly, companies might evaluate whether they should place or modify limits on cancellation of 10b5-1 Plans or on the number of 10b5-1 Plans that an individual may maintain simultaneously. While companies and their directors and officers do not need to change their Rule 10b5-1 practices until a final rule has been adopted and becomes effective, the time is right to analyze their practices and consider whether to modify any existing procedures in light of the proposal and its underlying concerns.

Because the proposal would add specific disclosure requirements regarding insider trading policies and procedures, now would be a good time for companies to generally review both their insider trading policies and procedures to determine if any updates are advisable.

The proposal will increase visibility of insider gifts of company securities and Chair Gensler made clear in his statement in support of the proposal that "charitable gifts of securities are subject to insider trading laws."[5] In this environment, companies may want to review their insider trading policies to consider whether it would be appropriate to add or modify provisions addressing the extent to which their insider trading policies apply to gifting.

If the SEC adopts final rules requiring quarterly disclosures regarding adoption or termination of 10b5-1 Plans, companies will need to devise appropriate disclosure controls to gather this information on a timely basis. Companies should start thinking about how they would implement such disclosure controls.

The proposal is subject to a 45-day comment period from the date it is published in the *Federal Register*.

See the SEC's announcement and proposing release.

For more information about the topics raised in this Legal Update, please contact any of the following authors.

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ENDNOTES

[1] See Gary Gensler, Prepared Remarks CFO Network Summit (Jun. 7, 2021), https://www.sec.gov/news/speech/gensler-cfo-network-2021-06-07; Recommendations of the Investor Advisory Committee Regarding Rule 10b5-1 Plans (Sept. 9, 2021), at https://www.sec.gov/spotlight/investor-advisory-committee-2012/20210916-10b5-1-recommendation.pdf.

[2] For this purpose, the SEC proposes to use the definition of "officer" contained in Rule 16a-1(f).

[3] The SEC notes that the ten-year retention requirement was chosen to sync with the ten-year statutes of limitations that govern the SEC's insider trading actions.

[4] As with other executive compensation requirements, the proposal provides that disclosure of this information in an annual report on Form 10-K may be incorporated by reference from a proxy or information statement involving the election of directors, if filed within 120 days of the end of the fiscal year.

[5] Gary Gensler, Statement on Rule 10b5-1 and Insider Trading (Dec. 15, 2021), at https://www.sec.gov/news/statement/gensler-10b5-20211215?utm_medium=email&utm_source=gov.