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"Good Corporate Hygiene" and the Regulation of Insider Stock Transactions

Bonnie J Roe; Cody Lipton

In a speech before the Economic Club of New York on November 19, 2020, outgoing SEC Chair Jay Clayton urged companies to adopt "good corporate hygiene" measures regulating insider trading and equity awards based on the company's stock price. Specifically, he recommended that all companies adopt policies and internal controls:

- To require a "cooling off" period between the adoption of an automatic trading plan under Rule 10b5-1 under the Securities Exchange Act (a "Rule 10b5-1 plan") by a company insider and the commencement of trading under such plan;
- To prohibit senior executives and directors from trading under Rule 10b5-1 plans when the company is in possession of material undisclosed information; and
- To ensure that stock options and other compensatory awards based on stock price are not priced when the company is in possession of positive material undisclosed information.

These recommendations go beyond what most practitioners believe to be legally required, as described below. Clayton nonetheless emphasized that they are needed not only to discourage insider trading but also to prevent the appearance of impropriety or misalignment of interests. The measures therefore should be implemented as a matter of good corporate governance, to demonstrate the company's commitment to integrity and to ensure that equity compensation provides genuine performance incentives. Clayton also suggested that Congress or the SEC might take action to require these measures. While Clayton has announced that he will leave the SEC at the end of this year, these proposals might well be taken up by the SEC next year.

One day prior to Clayton's remarks, on November 18, 2020, William H. Hinman, the outgoing Director of the SEC's Division of Corporation Finance, made essentially the same proposals, again using the term "good corporate hygiene," in remarks published in conjunction with an address before the PLI Directors' Institute on Corporate Governance. Like Clayton, he emphasized the importance of demonstrating integrity in a time of market volatility and media attention to insider trades. Like Clayton also, he paired good corporate hygiene with principles-based disclosure: in effect, companies should do the right thing, following principles rather than a narrow interpretation of the rules.

Rule 10b5-1 Trading Plans

Rule 10b5-1 plans enable insiders to dispose of their interests (or acquire new shares) by setting forth how the shares are to be sold or purchased, in advance, in a written plan that is typically administered by a broker, without further input from the insider. The insider may only enter into the plan at a time when the insider has no material undisclosed information. Because the insider cedes control over the planned trading, it is possible for a transaction to take place at a time when the insider has material information that is not publicly disclosed.

Typically, companies regulate the adoption of Rule 10b5-1 plans as part of the insider trading policies that govern when officers and directors may trade in company stock. Although not technically required by Rule 10b5-1, the typical plan imposes a cooling off period between the time of adoption and the time of the first trade; in some cases, the cooling off period is only 30 days, while in other cases it is 60 days, or extends until the company's next open trading window. With some exceptions, the plans do not require that trades be made only in company designated window periods, when insiders generally may purchase or sell stock. The theory is that it should not matter whether the company or the insider is in possession of inside information when a sale or purchase is made under an automatic plan that the insider cannot control. Yet the fact that trades are made in an advantageous manner, or at a time when (in retrospect) the company appears to have had undisclosed material information, has led to criticism of the plans. This happened most recently when drug company executives were criticized for sales that appeared to take advantage of speculation about the development of COVID-19 vaccines, when the sales were made pursuant to recently adopted Rule 10b5-1 trading plans. Public criticism of sales under Rule 10b5-1 plans has periodically led to proposals for reform through legislation, including the *Promoting Transparent Standards for Corporate Insiders Act*, which passed in the U.S. House of Representatives by a vote of 413-3 on January 18, 2019.

The Andeavor Consent Decree and Internal Control in Stock Buyback Transactions

A recent SEC consent decree emphasized that a corporation's required internal controls include the ability to accurately assess whether the corporation possesses material undisclosed information. *In the Matter of Andeavor LLC*, decided on October 15, 2020, involved a stock buyback plan under which the company itself purchased shares, relying on Rule 10b5-1 to permit purchases on behalf of the company pursuant to an automatic plan. In *Andeavor*, the company's board of directors had adopted a stock buyback plan under Rule 10b5-1 which prohibited purchases at a time when the company had material undisclosed information. The company's CEO directed the CFO to implement the plan a day before he recommenced discussions with a potential acquiring party. As described in the consent decree, the CEO knew it was likely that an agreement would be concluded with the acquiring party, and in fact a merger took place two months later. The company's legal department, however, was apparently unaware of the CEO's discussions or their significance and approved the implementation of the stock buyback plan.

In *Andeavor*, the failure to recognize the existence of material undisclosed information or its implications for the stock buyback plan represented a failure of the company's required internal control under Section 13(b)(2)(B) of the Securities Exchange Act. The SEC did not find that the company had intentionally traded on inside information, however, and a violation of Rule 10b-5 under the Securities Exchange Act was not alleged. Instead the SEC relied on the proposition that, before embarking on a stock buyback program or other transactions with its shareholders, a company should have sufficient internal control to understand when it was permissible for it to trade. Two commissioners (Elad L. Roisman and Hester M. Peirce) dissented from these findings, arguing that internal control over inside information was not the same as internal control over accounting, which is, arguably, all that is addressed by Section 13(b)(2)(B) of the Securities Exchange Act. While Roisman and Peirce acknowledged that the *Andeavor* fact pattern was problematic, in their view it did not involve internal control over accounting.

The theoretical weakness that Roisman and Peirce pointed to in the *Andeavor* case is the same as the weakness of Clayton's and Hinman's argument for good corporate hygiene. While companies may be held responsible for the misuse of nonpublic information by company insiders, the parameters of this responsibility, in the absence of intentional fraud, are unclear. As acknowledged by Clayton and Hinman, new regulation or statutory directives may be necessary.

What Should Companies and Insiders Do?

The corporate hygiene arguments of Clayton and Hinman, as well as the *Andeavor* consent decree, suggest that companies should take a careful look at their current practices around a couple of issues: the provisions of Rule 10b5-1 plans for executives and directors; the assessment of whether they possess material undisclosed information; and the timing of stock option grants and other equity awards that are priced on the date of grant. Specifically with respect to Rule 10b5-1 plans, companies may wish to require longer cooling off periods between the adoption of a plan and the commencement of trading, and they may also wish to require that trades only occur during company established window periods. In a changing regulatory environment, both companies and their insiders may wish to give more consideration to avoiding the appearance of impropriety, and upholding good corporate practices.

The Authors:

Bonnie J Roe
Partner

+1 212 707 1331
broe@cohengresser.com

Cody Lipton
Associate

+1 212 324 3514
clipton@cohengresser.com

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New York | Paris | Washington DC | London

www.cohengresser.com
info@cohengresser.com
+1 212 957 7600

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