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SEC Adopts Amendments Revamping Rule 10b5-1 Trading Regime and Mandating Related Disclosures

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Background

On December 14, 2022, the Securities and Exchange Commission (the "Commission") adopted amendments bolstering the conditions to be met in order for a person to rely on the affirmative defense from insider trading available under Rule 10b5-1(c)(1) of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), and requiring a series of related disclosures.[1] At the heart of the new amendments is the Commission's agenda to preserve the integrity of the securities markets in recognition of the fact that over the years, some corporate insiders have manipulated Rule 10b5-1 plans to the detriment of investors.

The securities laws, including Section 10(b) and Rule 10b-5, and related case law generally prohibit a person's purchase or sale of a security of any issuer "on the basis of material nonpublic information" about that issuer, as further clarified by the Commission to mean while the person trading was "aware of" material nonpublic information regarding the issuer at the time of the transaction.[2] The affirmative defense provided in Rule 10b5-1(c) enables persons who are able to meet certain conditions to avoid liability under Section 10(b) and Rule 10b-5, even though they transacted in the securities of an issuer at a time when they were aware of material nonpublic information about the issuer.[3]/[4] The availability of this defense has led to the relatively widespread adoption and use of Rule 10b5-1 plans by issuers, insiders, and other market participants purchasing and selling securities over the past 22 years since the Commission first adopted the rule.

The final amendments seek to modernize the protection accorded to investors from insider trading by (1) placing limitations on the Rule 10b5-1(c)(1) affirmative defense to insider trading, (2) creating new disclosure requirements to keep potential investors abreast with issuers' insider trading policies and procedures, (3) providing investor oversight into the trading practices of directors and officers[5] in order to curtail opportunistic trading, and (4) increasing transparency in issuer equity compensation award practices in relation to the release of material nonpublic information. In its adopting release, the Commission asserted that the amendments would bolster investor confidence in the securities markets, enhance capital formation for businesses, and help curb fraudulent misuse of insider information while at the same time granting insiders the freedom to establish parameters for future trades at a time when they are not in possession of material nonpublic information.[6] Given the popularity and opportunistic

use of Rule 10b5-1 plans, the amendments are likely to have significant implications for businesses and investors alike.

Effective and Compliance Dates

The final rules will become effective 60 days after they are published in the Federal Register, and any Rule 10b5-1 plans entered into after that date will be subject to the new requirements.[7] Note that the final rules do not affect the availability of the affirmative defense for existing Rule 10b5-1 plans entered into prior to the effective date of the rule (unless the plan is subsequently modified).[8] Compliance with the new disclosure and tagging requirements in Exchange Act reports and proxy / information statements is generally required in the first filing that covers the full fiscal period that starts on or after April 1, 2023 (or after October 1, 2023 in the case of smaller reporting companies ("SRCs")). Section 16 reporting persons will need to comply with the amendments to Forms 4 and 5 for reports filed on or after April 1, 2023.[9]

Impact on Affirmative Defense to Insider Trading Liability

Cooling-off Period

While Rule 10b5-1 prohibits the adoption of plans while a person is in the possession of material nonpublic information, policing of such condition is impracticable, and the Commission cited evidence to support insiders' misuse of information. Studies have found that, on average, trades made in the immediate aftermath of the adoption of Rule 10b5-1 plans tend to generate atypical profits.[10] In part to address these concerns, the Commission adopted a cooling-off period between the date of plan adoption and the date of the first transaction executed under the plan, which is generally applicable to persons other than the issuer. The length of the applicable cooling-off period varies, with directors and officers subject to a longer waiting period than others.

- Directors / Officers: Directors and officers are subject to a bifurcated waiting period equal to the longer of (1) 90 days post-plan adoption or (2) two business days following the issuer's filing of a quarterly report on Form 10-Q or an annual report on Form 10-K for the fiscal quarter in which the plan was adopted, subject to a 120-day cap.[11]

- Issuer: At this time, issuers will not be subject to a waiting period. However, the Commission is further considering whether, and to what extent, a cooling-off period should be implemented for issuers.[12]

- Other Persons: Other persons are subject to a 30 day cooling-off period.[13]

The amendments also codify the Commission's historic guidance that changes to the amount, price *or* timing of transactions under an existing Rule 10b5-1 plan constitute the termination of the plan and the adoption of a new plan that is subject to a refreshed cooling-off period. Conversely, modifications to a plan that do not impact the price, amount or timing of transactions are not subject to a renewed waiting period.[14]

Expanded Good Faith Condition

Currently, insiders can only rely on the affirmative defense to the extent they entered into the trading plan in good faith and "not as a part of a plan or scheme to evade the prohibitions of [the rule]."[15] The new rules bolster this prerequisite by adding an additional requirement that the plan generally be operated in good faith after its adoption. Per the final rule, persons seeking to avail themselves of the affirmative defense must have "acted in good faith with respect to" the Rule 10b5-1 plan.[16] This change

is geared at curtailing insiders' potential to game the rules by inappropriately influencing the timing of the disclosure of material nonpublic information to suit their pre-existing trading plans.[17]

Director and Officer Certifications

The Commission further highlighted the notion that acting in good faith underpins the availability of the affirmative defense by adopting a requirement that directors and officers include a certification in their Rule 10b5-1 plans stating that at the time of the adoption of the new or modified plan:

- the director or officer is unaware of material nonpublic information concerning the issuer or its securities; and
- the director or officer is adopting the plan in good faith and not to otherwise circumvent Rule 10b-5.[18]

In adopting the new certification, the Commission seeks to remind directors and officers that the onus is on them to determine whether or not they are aware of material nonpublic information, to underscore their duty to only adopt a Rule 10b5-1 plan if they are not aware of material nonpublic information, and to emphasize their obligation to act in good faith in order to avail themselves of the affirmative defense.[19]

Restrictions on Multiple Overlapping Rule 10b5-1 Plans

The new rules restrict the number of Rule 10b5-1 plans an insider may adopt at one time. The limitation of plans is designed to prevent insiders from circumventing the newly implemented cooling-off period requirements through strategically deploying and later terminating multiple overlapping plans while they are aware of material nonpublic information regarding the issuer. In addition, the new rules shore up the existing prohibition against hedging for insiders seeking to rely on the affirmative defense since multiple overlapping plans could also be selectively utilized in order to have the same effect as a hedging position.[20]

Accordingly, the new rules provide that as a condition to the availability of the affirmative defense, no person (other than the issuer) can have multiple Rule 10b5-1 plans in place at one time that are applicable to any class of the issuer's securities, subject to limited exceptions.[21]

Exception to the Restrictions on Multiple Overlapping Rule 10b5-1 Plans

A series of separate plans maintained with different broker-dealers may be construed as a single plan provided the plans, taken together, satisfy the requirements of Rule 10b5-1(c)(1) mentioned above.[22] In the same vein, the final rules permit a person to maintain two separate plans at the same time if the later-commencing plan would begin after completion of all trades under the earlier-commencing plan so long as trades under the later-commencing plan cannot begin until the completion of the "effective cooling-off period" (i.e., the cooling-off period that would otherwise be applicable to the later-commencing plan had it been adopted upon the termination of the earlier-commencing plan).[23] Furthermore, a person can still rely on the affirmative defense even though that person maintains an additional plan so long as the additional plan only pertains to eligible sell-to-cover transactions. Such plans facilitate an insider's sale of securities solely in order to meet his or her tax withholding obligations that stem from the vesting of a compensatory award (like a stock appreciation right or restricted stock), and the insider does not "otherwise" exert control over the timing of the sale. This exception does not extend to additional plans covering sales in connection with option exercises, though sales incident to option exercises can fall under the protection of the affirmative defense if otherwise provided for in a person's sole Rule 10b5-1 plan.[24]

Prohibition on Multiple Single-Trade Plans

In light of research showing that single-trade plans are "consistently loss-avoiding" and "often precede stock price declines", the Commission elected to restrict the number of single-trade plans persons (other than the issuer) can utilize in a one-year period.[25] Single-trade plans are plans "designed to effect" the purchase or sale of the whole amount of securities covered by the plan in one transaction.[26] Pursuant to the new rule, persons cannot rely on the affirmative defense to adopt a single-trade Rule 10b5-1 plan unless they have not adopted another single-trade Rule 10b5-1 plan within the preceding 12-month period.[27] Plans limited to sell-to-cover transactions are excluded from the limitation.[28]

Impact on Disclosures

Currently, issuers are not required to disclose their insider trading polices or procedures or information regarding any Rule 10b5-1 trading arrangements entered into by directors or officers.[29] The final rules add new quarterly and annual disclosure obligations regarding these matters, under new Items 402(x) and 408 of Regulation S-K.[30]

Quarterly Disclosures

On a quarterly basis, an issuer (including SRCs and emerging growth companies ("EGCs")) must disclose in its Form 10-Q or Form 10-K, as applicable, whether any of its directors or officers have adopted or terminated (1) a trading arrangement intending to qualify for the affirmative defense conditions of Rule 10b5-1(c) or (2) a "non-Rule 10b5-1 trading arrangement" (as defined by new Item 408(c) as certain other pre-planned trading contracts, instructions, or plans entered into by a director or officer when they were not aware of material nonpublic information that would not otherwise qualify for the affirmative defense). The disclosure must also include the material terms of the plan, other than pricing information, and indicate whether the plan is a Rule 10b5-1 plan or a non-Rule 10b5-1 plan.[31] These disclosures are subject to Inline XBRL tagging requirements.[32]

Annual Disclosures

Under the new rules, issuers will further need to provide disclosure in their Form 10-K (or Form 20-F, in the case of a foreign private issuer) and proxy or information statements regarding whether or not they have adopted insider trading policies and procedures. To the extent that an issuer has not adopted insider trading policies or procedures, it will need to provide an explanation for the decision. Rather than providing duplicate disclosure in an issuer's Form 10-K and annual meeting proxy statement, it is anticipated that issuers will elect to utilize General Instruction G to Form 10-K to incorporate by reference the disclosure into their Form 10-K from their annual meeting proxy statement (filed within the 120 day post-fiscal year-end deadline). Issuers will also be required to file a copy of their insider trading policies and procedures as an exhibit to their Form 10-K.[33]

Furthermore, the new rules call for expanded executive compensation disclosure regarding option award grants made close in time to the release of material nonpublic information. The requirement is twofold. First, issuers must discuss their "policies and practices" related to the timing of option (and option-like) grants, including whether the timing of the release of material nonpublic information is considered when choosing the grant date or whether the timing of the release of such information was purposefully made to affect the award's value. Second, if issuers made option (or option-like) awards to any named executive officers during certain periods of time during the last completed fiscal year, they must provide tabular disclosure regarding such grants. The new table includes columns for basic award details, as well as the percentage change in the closing market price of the securities underlying the award from the day prior to and the day after the disclosure of material nonpublic information.[34] The tabular

disclosure is required for awards made during the period beginning four business days prior to (1) the filing or furnishing of current reports on Form 8-K disclosing material nonpublic information, with certain exceptions, or (2) the filing of a periodic report (i.e., Form 10-Q or Form 10-K), and ending one business day after the precipitating event.[35] Once again, SRCs and EGCs are not exempt from these requirements and these disclosures are subject to Inline XBRL tagging requirements.[36]

Impact on Forms 4 and 5

The Commission seeks to increase transparency regarding the use of Rule 10b5-1 plans and to further curtail abusive practices through the addition of a new checkbox to Forms 4 and 5 in which Section 16 reporting persons must indicate whether the transactions being reported in the applicable form were made pursuant to a trading plan "intended to satisfy" the affirmative defense. Filers who check the box must provide the date on which the plan was adopted in the "Explanation of Responses."[37]

Finally, the new rules require bona fide gifts made by Section 16 reporting persons to be reported on a Form 4 filed within two business days of the transaction, as opposed to on Form 5 within 45 days of the issuer's fiscal year end.[38]

Recommendations

In-house legal teams should familiarize themselves with the new insider trading disclosure regime and communicate the changes to the availability of the affirmative defense and the company's new disclosure obligations to the issuer's directors and officers. The new requirements should also be clearly disseminated to the issuer's non-officer employees as they will be subject to the revised standards of the affirmative defense as well as a 30-day cooling-off period. Since issuers' insider trading policies and procedures will now be publicly available, management and boards of directors should review any such policies and procedures in addition to evaluating and overseeing their compliance with the new rules. Management should also conduct a review of the issuer's disclosure controls and procedures surrounding directors' and officers' adoption, modification, or termination of trading arrangements to ensure the issuer will be able to adhere to the new quarterly and annual disclosure requirements. Similarly, in-house counsel should revise Section 16 reporting practices to take into account the new checkboxes and the compressed timeline for reporting bona fide gifts. Boards of directors should evaluate their policies and practices related to the timing of the release of material nonpublic information and its relationship with the timing of and impact on option award grants. Finally, insiders should take a hard look at their trading practices to avoid losing the ability to rely on the affirmative defense once the new rules are in place.

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If you have any questions concerning these developing issues, please do not hesitate to contact the following Paul Hastings lawyer:

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[1] *Insider Trading Arrangements and Related Disclosures*, Release No. 33-11138; 34-96492 (adopted December 14, 2022) [hereinafter the *"Adopting Release"*], at p. 10, https://www.sec.gov/rules/final/2022/33-11138.pdf.

[2] *Id.* at p. 6-7.

[3] Exchange Act Rule 10b5-1(c).

[4] Rule 10b5-1(c) provides an affirmative defense to persons in circumstances where the trade was executed under a binding contract, under an instruction to another person, or under a written trading plan adopted in good faith prior to the insider becoming privy to material nonpublic information.

[5] Section 16 officers are considered "officers" for the purposes of this rule.

[6] *Adopting Release*, *supra* note 1 at p. 10-11.

[7] *Id.* at p. 2.

[8] *Id.* at p. 116.

[9] *Id.* at p. 115.

[10] *Id.* at p. 17.

[11] For foreign private issuers, the second prong is tied to the issuer's filing of its financial results on Form 20-F or Form 6-K, as applicable.

[12] *Adopting Release*, *supra* note 1 at p. 37.

[13] *Id.* at p. 34

[14] *Id.* at p. 36.

[15] Exchange Act Rule 10b5-1(c)(1)(ii).

[16] *Adopting Release*, *supra* note 1 at p. 66.

[17] *Id.* at p. 64.

[18] *Id.* at p. 41.

[19] *Id.* at p. 38.

[20] *Id.* at p. 47-48.

[21] *Id.* at p. 55.

[22] *Id.* at p. 56.

[23] *Id.* at p. 57-58.

[24] *Id.* at p. 58-59.

[25] *Id.* at p. 49.

[26] *Id.* at p. 61.

[27] *Id.* at p. 60.

[28] *Id.* at p. 63.

[29] *Id.* at p. 68.

[30] *Id.* at p. 75-76.

[31] *Id.* at p. 76.

[32] *Id.* at p. 106.

[33] *Id.* at p. 84-85.

[34] *Id.* at p. 103.

[35] *Id.* at p. 102.

[36] *Id.* at p. 80 and 106.

[37] *Id.* at p. 92.

[38] *Id.* at p. 111.