Investor Alert

Labaton Sucharow

Privileged & Confidential | Attorney Work Product

SEC AMENDMENTS TO RULE 10B5-1 INSIDER TRADING PLANS AND RELATED DISCLOSURES

On December 14, 2022, the Securities and Exchange Commission ("SEC") unanimously adopted amendments to Rule 10b5-1 under the Securities Exchange Act of 1934 (the "Exchange Act") and new disclosure requirements to close loopholes that insiders have used to abuse the rule's liability protections since its inception. As discussed further below, these amendments add new conditions to the availability of the affirmative defense under Exchange Act Rule 10b5-1(c)(1), including cooling-off periods for directors, officers, and persons other than issuers. The amendments also require related disclosures, including new disclosure requirements for: issuers' insider trading policies, the adoption and termination of Rule 10b5-1 trading plans by directors and officers, and equity compensation awards made close in time to the issuer's disclosure of material nonpublic information ("MNPI"). The amendments even include updates to Forms 4 and 5 to require filers to identify transactions made pursuant to a plan that is intended to satisfy the affirmative defense conditions of Rule 10b5-1(c) and to disclose all bona fide gifts of securities on Form 4. Ultimately, these amendments are expected to strengthen investor confidence by curbing most of the abuses associated with Rule 10b5-1 trading plans.

Rule 10b5-1

In 2000, the SEC adopted Rule 10b5-1 to provide more clarity regarding the meaning of "manipulative or deceptive device[s] or contrivance[s]" prohibited by Section 10(b) of the Exchange Act and Rule 10b-5 with respect to trading on the basis of MNPI.[1] At the time, there was a circuit split on the issue of what, if any, connection must be shown between a trader's possession of MNPI and his or her trading to establish liability under Section 10(b) and Rule 10b-5.[2] The SEC addressed this issue by adopting Rule 10b5-1, which provided that a purchase or sale of an issuer's security is on the basis of MNPI if the insider making the purchase or sale *was aware of* the MNPI when the insider made the purchase or sale.[3] In addition, Rule 10b5-1(c) established an affirmative defense to liability under Section 10(b) and Rule 10b-5 for insider trading, which the SEC intended "to cover situations in which a person can demonstrate that the material nonpublic information did not factor into the trading decision."[4] This affirmative defense provided a safe harbor for

[1] *Selective Disclosure and Insider Trading*, Release No. 33-7881 (Aug. 15, 2000) [65 FR 51716 (Aug. 24, 2000)] ("2000 Adopting Release").
[2] *Insider Trading Arrangements and Related Disclosures*, Release Nos. 33-11138; 34-96492 (Dec. 14, 2022) ("Proposed Rule for Rule 10b5-1 Trading Plans and Related Disclosures").
[3] *See* 17 CFR 240.10b5-1.
[4] 2000 Adopting Release, *supra* note 1 at 51728.

trading so long as the insider can demonstrate, among other things, that the trade was made pursuant to a binding contract or a written plan for the trading of securities ("Rule 10b5-1 trading plan") adopted at a time when the insider was not aware of MNPI.[5] The SEC believed that this defense would "provide appropriate flexibility to those who would like to plan securities transactions in advance, at a time when they are not aware of material nonpublic information, and then carry out those pre-planned transactions at a later time, even if they later become aware of material nonpublic information."[6]

Loopholes and Associated Abuses to Rule 10b5-1 Trading Plans

Despite the good intentions justifying the adoption of the rule, Rule 10b5-1 creates loopholes that have allowed opportunistic insiders to shield their trades from regulatory scrutiny. There are various ways an insider can abuse the rule, including strategically implementing, modifying, and canceling Rule 10b5-1 trading plans in advance of public disclosures containing material information. While an insider is prohibited from implementing or modifying a Rule 10b5-1 trading plan when aware of MNPI, there is no requirement to report the implementation or modification of a plan—allowing many insiders to escape regulatory scrutiny altogether. Further, SEC guidance previously permitted insiders to cancel Rule 10b5-1 trading plans while in possession of MNPI because the termination of a plan technically does not constitute a securities transaction (*i.e.*, the purchase or sale of a security).[7]

Academic studies confirm that insiders have engaged in, at the very least, some level of strategic trading through Rule 10b5-1 trading plans.[8] Most recently, an examination of a dataset containing over 20,000 Rule 10b5-1 trading plans, including respective adoption dates and trades, revealed three "red flags" associated with the use of such plans: (1) plans with short "cooling-off periods;"[9] (2) plans that entail only a single

[5]Rule 10b5-1 does not modify or address any other aspect of insider trading law. It also does not provide an affirmative defense for other securities fraud claims, such as a claim under Rule 10b-5 for an "untrue statement of a material fact." 17 CFR 240.10b-5(b).
[6]2000 Adopting Release, *supra* note 1 at 51728.
[7]SEC Exchange Act Rules, "*Questions and Answers of General Applicability*," specifically Questions 120.17 & 120.18, (stating that, standing alone, termination of a plan does not result in liability under Rule 10b-5, although alteration of a plan can eliminate the Rule 10b5-1(c) defense for prior transactions, if any, under the plan).
[8]*See, e.g.*, David F. Larcker, *et al.*, *Gaming the System: Three "Red Flags" of Potential 10b5-1 Abuse*, Stan. Closer Look Series, Corp. Governance Res. Series 1 (Jan. 2021) (Authors examine 20,000 Rule 10b5-1 trading plans, including associated adoption dates and trades, and find that a subset of executives used Rule 10b5-1 trading plans to engage in opportunistic, large-scale selling of company shares, typically in advance of considerable stock declines to avoid significant losses.); Alan D. Jagolinzer, *SEC Rule 10b5-1 and Insiders' Strategic Trade*, Management Science (Feb. 2009), (Authors examine Rule 10b5-1 trading activity in 1,241 companies, finding that sales executed under Rule 10b5-1 trading plans appear to occur after price increases and before price declines, resulting in statistically significant forward-looking abnormal returns.).
[9]The term "cooling-off period" refers to the elapsed time between plan adoption and the date of the first planned trade.

trade; and (3) plans adopted in a given quarter that begin trading before that quarter's earnings announcement.[10] Ultimately, this examination found that a subset of insiders engaged in opportunistic, large-scale selling of company shares—enabling insiders to avoid significant losses.[11]

Amendments to Rule 10b5-1 and Related Disclosures

On December 14, 2022, the SEC adopted amendments to Rule 10b5-1 and new disclosure requirements to help close the loopholes referenced above.[12] The rule changes amend the Rule 10b5-1(c)(1) affirmative defense to insider trading liability to include:

- A cooling-off period for directors and officers of the later of: (1) 90 days following plan adoption or modification; or (2) two business days following the disclosure in certain periodic reports of the issuer's financial results for the fiscal quarter in which the plan was adopted or modified (but not to exceed 120 days following plan adoption or modification) before any trading can commence under the Rule 10b5-1 trading plan;
- A cooling-off period of 30 days for persons other than issuers or directors and officers before any trading can commence under the Rule 10b5-1 trading plan or modification;
- A condition for directors and officers to include a representation in their Rule 10b5-1 plan certifying, at the time of the adoption of a new or modified plan, that: (1) they are not aware of MNPI about the issuer or its securities; and (2) they are adopting the plan in good faith and not as part of a plan or scheme to evade the prohibitions of Rule 10b-5;
- A limitation on the ability of anyone other than issuers to use multiple overlapping Rule 10b5-1 trading plans;
- A limitation on the ability of anyone other than issuers to rely on the affirmative defense for a single-trade, Rule 10b5-1 trading plan to one such plan during any consecutive 12-month period;[13] and
- A condition that all persons entering into a Rule 10b5-1 trading plan must act in good faith with respect to that plan.

[10] Larcker, Gaming the System: Three "Red Flags" of Potential 10b5-1 Abuse, *supra* note 8.
[11] *Id.*
[12] SEC Press Release, *SEC Adopts Amendments to Modernize Rule 10b5-1 Insider Trading Plans and Related Disclosures*, 2022-222 (Dec. 14, 2022) ("SEC December 14, 2022 Press Release").
[13] In other words, the affirmative defense would not be available for a single-trade, Rule 10b5-1 plan if the insider had purchased or sold securities pursuant to another single trade plan within the preceding 12-month period. *See* Proposed Rule for Rule 10b5-1 Trading Plans and Related Disclosures, *supra* note 2.

The amendments also create new disclosure requirements that include:

- Quarterly disclosure by registrants regarding the use of Rule 10b5-1 trading plans and certain other written trading arrangements by a registrant's directors and officers for the trading of its securities;
- Annual disclosure of a registrant's insider trading policies and procedures;
- Certain tabular and narrative disclosures regarding awards of options close in time to the release of MNPI and related policies and procedures;
- Tagging of the required disclosures;[14] and
- A requirement that Form 4 and 5 filers indicate by checkbox that a reported transaction was intended to satisfy the affirmative defense conditions of Rule 10b5-1(c).

The final rules will become effective 60 days following publication of the adopting release in the Federal Register.[15] Section 16 reporting persons will be required to comply with the amendments to Forms 4 and 5 for beneficial ownership reports filed on or after April 1, 2023.[16] Issuers will be required to comply with the new disclosure requirements in Exchange Act periodic reports on Forms 10-Q, 10-K, and 20-F and in any proxy or information statements in the first filing that covers the first full fiscal period that begins on or after April 1, 2023.[17] The final amendments defer, by six months, the date of compliance with the additional disclosure requirements for smaller reporting companies.[18]

Labaton Sucharow's lawyers are available to address any questions you may have regarding these developments. Please contact the Labaton Sucharow lawyer with whom you usually work or the contacts below.

Eric J. Belfi:
ebelfi@labaton.com / 212.907.0878

Charles J. Stiene:
cstiene@labaton.com / 212.907.0703

[14]Registrants are required to tag the information specified by new Items 402(x), 408(a), and 408(b)(1) of Regulation S-K, and new Item 16J(a) of Form 20-F, in Inline XBRL in accordance with Rule 405 and the EDGAR Filer Manual. *See* Proposed Rule for Rule 10b5-1 Trading Plans and Related Disclosures, *supra* note 2.

[15]SEC December 14, 2022 Press Release, *supra* note 12.
[16]*Id.*
[17]*Id.*
[18]*Id.*