SEC Updates Rule 10b5-1 on Insider Trading

On December 14, 2022, the SEC unanimously approved a final rule updating insider trading rules and related disclosures. Highlights include:

- Mandatory cooling-off periods for directors, officers, and other persons—other than the issuer—for newly adopted or modified Rule 10b5-1 trading plans
- Enhanced the affirmative defense requirements under Rule 10b5-1
- New disclosures on insider trading plans, policies, and procedures
- Updated filing requirements for gifts of securities

Issuers should review and revise, if needed, their insider trading and equity grant policies.

Background & Current Guidance

The SEC adopted Rule 10b5-1 in 2000 to clarify when a purchase or sale of a security by a listed company or corporate insider in possession of material nonpublic information (MNPI) may be subject to legal liability and potential enforcement action. A trade is considered on the basis of MNPI—and subject to scrutiny under insider trading restrictions—if the person or entity making the purchase or sale was aware of the MNPI when the trade was executed. To provide flexibility to insiders wishing to adopt securities trading plans and strategies, Rule 10b5-1(c) established an affirmative defense to insider trading provided trades under these plans adhere to the following three conditions:

- The contract, instruction, or plan is adopted in good faith prior to the insider becoming aware of MNPI
- The plan:
  - Specifies the amount, price, and date of securities to be purchased or sold, or
  - Provides written instructions or a formula that would trigger purchase or sale of securities, including the amount, price, and date of any trades, or
  - Does not permit the insider to exercise subsequent influence over how, when, or whether trades are made once a plan is established, provided that the plan is established when the insider is not aware of MNPI
- The purchase or sale of securities was pursuant to the contract, instruction, or plan

1. Mandatory Cooling-Off Periods

Currently, there is no waiting period between a trading plan arrangement's adoption date and the date the first trade is executed under the plan. The final rule specifies that only a change to the amount, price, or timing will trigger a cooling-off period.

Directors' & Officers' Purchases

The final rule requires a mandatory cooling-off period for directors and Section 16 officers before any trading on a 10b5-1 plan, the later of:

- 90 days following a newly adopted or modified Rule 10b5-1 trading plan, or
- Two business days following the disclosure of the issuer's financial results in a Form 10-Q or Form 10-K for the fiscal quarter in which the plan was adopted, not to exceed 120 days from plan adoption

The purpose of a cooling-off period is to provide a separation in time between plan adoption and the commencement of trading under the plan to minimize the ability of an insider to benefit from any MNPI. Any such information will be stale by the time trades are made.

Other Persons

A cooling-off period of 30 days for persons other than directors, officers, or the issuer is required before any trading can commence.

In a change from the proposal, no cooling-off periods will be required for issuer repurchases.

2. Affirmative Defense Changes

Since its adoption, Rule 10b5-1(c)(1) has required, as a condition of the affirmative defense, that a person demonstrate that they adopted their trading plan before becoming aware of MNPI and that the trading arrangement was *entered* into in good faith. The final rule expands the good faith provision to include that the Rule 10b-5 arrangement is *operated* in good faith with respect to the contract, instruction, or plan. This change addresses the SEC's concern that an insider could manipulate the timing of release of corporate information to benefit an officer's or director's planned trade.

New Representation

The final rule will require a new written representation (not a certification as proposed) from directors and officers certifying that they are not aware of MNPI when adopting or modifying a Rule 10b5-1 plan and that they are adopting the plan in good faith and not as part of a plan or scheme to evade any Rule 10b-5 prohibitions.

Limits on Multiple Plans

The SEC was concerned insiders could exploit MNPI by setting up multiple overlapping plans for hedging, and then canceling execution of the hedge's unfavorable side, while permitting execution of the favorable transaction. Similarly, a person could circumvent the cooling-off period by setting up multiple overlapping Rule 10b5-1 trading arrangements and deciding later which trades to execute and which to cancel after they become aware of MNPI, but before its release. To prevent this, the affirmative defense will not be available for overlapping plans or to more than one single-trade plan during any consecutive 12-month period, other than issuers. This applies to all persons, not just officers and directors.

In a change from the proposal, the final rule does not limit the number of plans for an issuer.

The final rule provides that a broker-dealer or other agent executing trades on behalf of the insider under a Rule 10b5-1 plan may be substituted by a different broker-dealer or agent as long as the purchase or sales instructions applicable to the substituted broker and the substitute are identical, including the prices of securities to be purchased or sold, dates of the purchases or sales to be executed, and amount of securities to be purchased or sold. However, a transferred arrangement that changes the purchase or sale amount, price, or date on which purchases or sales are to be executed is a termination of such plan and the adoption of a new plan.

A person—other than the issuer—can maintain two separate Rule 10b5-1 plans at the same time if trading under the later-commencing plan is not authorized to begin until after all trades under the earlier-commencing plan are completed or expire without execution. The first trade under the second plan must be made be after the cooling-off period.

An insider will not lose the benefit of the affirmative defense for an otherwise eligible Rule 10b5-1 plan if the insider has in place another plan that would qualify for the affirmative defense if that additional plan(s) only authorizes qualified sell-to-cover transactions (the sale of securities to satisfy tax-withholding obligations at the time an award vests). This provision only applies if the plan authorization covers only the securities necessary to satisfy the award's tax-withholding obligations and the insider does not otherwise exercise control over the timing of such sales. This applies only to restricted stock or stock appreciation rights and does not apply to the exercise of option awards.

The prohibition against multiple plans would not apply to transactions where a person acquires (or sells) securities through participation in employee stock ownership plans or dividend reinvestment plans that are not executed by the person on the open market.

Limits on Single Plans

A person—other than the issuer—will be able to rely on the affirmative defense for only one single-trade plan during any 12-month period. This defense will only be available if the person had not—during the preceding 12-month period—adopted another single-trade plan where the other plan qualified for the affirmative defense.

The sell-to-cover provision noted above also will apply to single plans.

3. New Disclosures

Currently, there are no mandatory disclosures on the use of Rule 10b5-1 trading arrangements. The final rule adds Item 408 under Regulation S-K and corresponding amendments to Forms 10-Q and 10-K to require quarterly disclosure of the use of Rule 10b5-1 and other trading arrangements by a registrant's directors and officers for the trading of the issuer's securities and annual disclosure of a registrant's insider trading policies and procedures. These disclosures would be subject to Sarbanes-Oxley Act certifications. Amendments to Forms 4 and 5 would require insiders to identify whether a reported transaction was executed pursuant to a Rule 10b5-1(c) trading arrangement.

Item 408(a) of Regulation S-K would require registrants to disclose:

- Whether, during the registrant's last fiscal quarter, any director or officer has adopted or terminated any contract, instruction, or written plan for the purchase or sale of the registrant's equity securities that is intended to satisfy the affirmative defense conditions of Rule 10b5-1(c)—and provide a description of the contract's material terms (excluding price) such as :

    - The name and title of the director or officer

- The date of adoption or termination of the trading plan
- The duration of the trading arrangement
- The aggregate number of securities to be sold or purchased under the trading arrangement

These disclosures would apply to both Rule 10b5-1 and non-Rule 10b5-1 trading plans. The final rule characterizes a non-Rule 10b5-1 trading arrangement as follows: where the director or officer asserts that, at a time when they were not aware of MNPI about the security or its issuer, they:

- Adopted a written arrangement for trading the securities, and
- The trading arrangement:

  - 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 subsequently purchased or sold
  - 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 the securities were to be purchased or sold, or
  - Did not permit the covered person to exercise any subsequent influence over how, when, or whether to effect purchases or sales; provided, in addition, that any other person who, pursuant to the trading arrangement, did exercise such influence must not have been aware of MNPI when doing so

Insider Trading Policies & Procedures

The final rule adds new Item 408(b) to Regulation S-K, which would require registrants to disclose whether the registrant has adopted insider trading policies and procedures governing the purchase, sale, and other dispositions of the registrant's securities by directors, officers, and employees or the registrant itself that are reasonably designed to promote compliance with insider trading laws, rules, and regulations and applicable listing standards. If a registrant has not adopted insider trading policies and procedures, it must explain why it has not done so. If the registrant has adopted insider trading policies and procedures, it would disclose such policies and procedures.

The final rule does not specify all details that a registrant should address in its insider trading policies, nor does it prescribe any specific language that such policies must include.

Executive & Director Compensation

Many companies use stock options as a form of employee compensation for executives. If a company is aware of MNPI that is likely to decrease its stock price, it may decide to delay a planned option award until after the information is released. 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 MNPI. Under current rules, compensation-related equity interests (including options, restricted stock, and similar grants) are required to be presented in a table with appropriate narrative to understand the information presented. Option grants that are spring-loaded or bullet-dodging are not required to be separately identified in these tables.

The final rule amends Item 402 of Regulation S-K to require *tabular* disclosure of each option award (including the number of securities underlying the award, grant date, the grant date fair value, and the option's exercise price) granted within four business days before the filing of a periodic report or the filing or furnishing of a current report on Form 8-K that contains MNPI (including earning information) and ending one business day after a triggering event. The window is designed to cover the period that a company would be aware of MNPI at the time that its board of directors grants an option award.

The final rules provide that if, during the last completed fiscal year, stock options, stock appreciation rights (SARs), and/or similar option-like instruments were awarded to a named executive officer (NEO) within a period starting four business days before the filing of a periodic report on Form 10-Q or Form 10-K, or the filing or furnishing of a current report on Form 8-K that discloses MNPI (including earnings information), other than a current report on Form 8-K disclosing a material new option award grant under Item 5.02(e), and ending one business day after a triggering event, the issuer must provide the following details for each award to the NEO on an aggregated basis in a tabular format:

- The name of the NEO
- The grant date of the award
- The number of securities underlying the award
- The per-share exercise price
- The grant date fair value of each award computed using the same methodology as used for the registrant's financial statements under GAAP
- The percentage change in the market price of the underlying securities between the closing market price of the security one trading day prior to and one trading day following the disclosure of MNPI

New Item 402(x) requires *narrative* disclosure about a registrant's grant policies and practices on the timing of stock options, SARs, and similar options like instruments 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 an award's timing and terms and if the disclosure of MNPI was timed to affect the value of executive compensation.

These changes would apply to smaller reporting companies (SRCs) and emerging growth companies (EGCs). SRCs and EGCs would be permitted to limit their disclosures about specific option awards to the program executive officer (PEO), the two most highly compensated executive officers other than the PEO at fiscal year-end, and up to two additional individuals who would have been the most highly compensated but for not serving as executive officers at fiscal year-end.

4. Gifts of Securities

Currently, Section 16 reporting persons—insiders—are required to report any gift of registered equity securities on Form 5. In general, covered individuals must file a Form 5 within 45 days after the issuer's fiscal year-end to disclose certain beneficial ownership transactions and holdings not reported on Forms 3, 4, or 5. However, gift transactions are eligible for delayed reporting on Form 5, which can permit insiders to report gifts more than one year after the gift date.

The final rule will require an officer, director, or a beneficial owner of more than 10% of the issuer's registered equity securities to report any equity gifts on Form 4 before the end of the second business day following the transaction execution date.

This new mandatory Form 4 disclosure requirement is intended to limit insiders gifting securities while they hold MNPI or backdating a stock gift to maximize a donor's tax benefit. The SEC notes that the majority of insiders already report gift transactions on Form 4.

Effective Date & SRC Accommodations

These changes do not affect the affirmative defense available under an existing plan that was entered into prior to the rule's effective date, except if the plan is modified or changed after the final rule's effective date. In that case, the modification or

change would be treated as adopting a new trading arrangement and these amendments would apply to the modified arrangement.

Section 16 reporting persons will be required to comply with Forms 4 and 5 amendments for beneficial ownership reports filed on or after April 1, 2023.

SRCs will be required to comply with the new disclosure and tagging requirements in Exchange Act periodic reports on Forms 10-Q, 10-K, and 20-F and in any proxy or information statements that are required to include the Item 408, Item 402(x), and/or Item 16J disclosures in the first filing that covers the first full fiscal period that begins on or after October 1, 2023.

All other issuers will be required to comply with the new disclosure and tagging requirements in Exchange Act periodic reports on Forms 10-Q, 10-K, and 20-F and in any proxy or information statements that are required to include the Item 408, Item 402(x), and/or Item 16J disclosures in the first filing that covers the first full fiscal period that begins on or after April 1, 2023.

Conclusion

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