Articles + Publications | January 4, 2023

SEC Adopts Final Rule Amendments for Rule 10b5-1 Trading Plans and Creates New Disclosure Requirements

WRITTEN BY

Jay A. Dubow | James E. Earle | David I. Meyers | Betty Linkenauger Segaar | Danilo P. Castelli | Zach M. Corenblum

Overview

On December 14, 2022, the Securities and Exchange Commission (SEC) adopted amendments and certain enhanced disclosure requirements related to Rule 10b5-1 trading plans. The new amendments include:

- Additional conditions to avail oneself of the Rule 10b5-1 affirmative defense to insider trading liability, including:
  - New cooling-off periods for directors, officers, and certain other individuals (but not companies);
  - A requirement that directors and officers include a certification in the Rule 10b5-1 trading plan at the time of entering into or modifying such plan;
  - Restrictions on the ability of an individual (other than a company) to use multiple overlapping Rule 10b5-1 trading plans, subject to certain exceptions; and
  - Limitations on the ability of an individual (other than a company) to rely on Rule 10b5-1 for more than a single-trade Rule 10b5-1 trading plan during any 12-month period.
- Additional company disclosure requirements, including:
  - Quarterly disclosure related to the adoption, modification, or termination of Rule 10b5-1 trading plans and certain other trading arrangements on an individualized basis by a company's directors and officers;
  - Annual disclosure related to a company's insider trading policies and procedures and the filing of such insider trading policies and procedures as an exhibit to the company's annual report; and
  - Tabular and narrative disclosures related to the timing of equity award grants to specified insiders.
- Amending Section 16 Forms 4 and 5 to require Section 16 insiders to identify transactions made under Rule 10b5-1 trading plans and to require disclosure of gifts of securities within two business days on Form 4 rather

than annually on a Form 5.

The final rules become effective February 27, 2023. The new rules will not impact existing Rule 10b5-1 trading plans or new or modified Rule 10b5-1 trading plans entered into prior to February 27, 2023. Companies will be required to comply with the new disclosure requirements in 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. 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. The final amendments defer by six months (or until October 1, 2023) the date of compliance with the additional disclosure requirements for smaller reporting companies (SRCs).

Rule 10b5-1 Background

Section 10(b) of the Securities and Exchange Act of 1934, as amended (Exchange Act), and Rule 10b-5 promulgated thereunder, prohibit the purchase or sale of a company's securities on the basis of material nonpublic information about the securities or the company in breach of a duty of trust and confidence owed to the company, its stockholders, or any other person who is the source of the material nonpublic information. Rule 10b5-1 under of the Exchange Act provides companies and their insiders an affirmative defense to such insider trading liability for trades that meet certain conditions designed to ensure that the decision to purchase or sell securities, as well as the terms of the purchase or sale, were not based on material nonpublic information. Such Rule 10b5-1 trading plans must be made in good faith at a time when the company or company insider does not possess material nonpublic information and not with the intent to evade the insider trading prohibitions. A Rule 10b5-1 trading plan must (1) specify the amount of securities to be purchased or sold and the price and date at which the securities are to be purchased or sold; (2) include a written formula, algorithm, or computer program for determining the amount of securities to be purchased or sold and the price and date at which the securities are to be purchased or sold; or (3) prohibit the person entering into the Rule 10b5-1 trading plan from exercising any subsequent influence over how, when, or whether to effect purchases or sales, provided that the broker/dealer who did exercise such influence must not have been aware of the material nonpublic information when doing so.

To address concerns that corporate insiders may be abusing the Rule 10b5-1 affirmative defense while trading securities opportunistically on the basis of material nonpublic information, the new rules add additional conditions for insiders to utilize the Rule 10b5-1 affirmative defense. These include the adoption of a mandatory cooling-off period, additional director and officer certifications, restrictions on the use of multiple overlapping Rule 10b5-1 trading plans and single-trade Rule 10b5-1 trading plans, and revisions to the good faith condition set forth in Rule 105b-1(c)(1).

New Cooling-Off Period

The new rules require Rule 10b5-1 trading plans adopted (or modified) by a director or an "officer" (as defined in Rule 16a-1(f)) (Section 16 Officer) to include a cooling-off period lasting until the later of: (1) 90 days following the adoption or modification of the Rule 10b5-1 trading plan or (2) two business days following the filing of the Form 10-Q or Form 10-K for the fiscal quarter in which the Rule 10b5-1 trading plan was adopted or modified. The required cooling-off period is subject to a maximum of 120 days after the adoption of a Rule 10b5-1 trading plan.

For persons other than the company, its directors, or Section 16 Officers, the new rules require a shorter 30-day cooling-off period before any trading can commence under the Rule 10b5-1 trading plan after its adoption or modification.

As noted above, modifications to existing Rule 10b5-1 trading plans also trigger a new cooling-off period. Modifications or changes to the amount, price, or timing of the purchase or sale of securities covered by the Rule 10b5-1 trading plan (or a modification or change to a written formula or algorithm or computer program that affects that amount, price, or timing of the purchase or sale of securities) will trigger a new cooling-off period.

The new rules do not impose a cooling-off period for company share repurchase plans.

Director and Section 16 Officer Certifications

As a condition to the availability of the Rule 10b5-1 affirmative defense, a director or Section 16 Officer must include written representations in the Rule 10b5-1 trading plan certifying that at the time of the adoption of a new or modified Rule 10b5-1 trading plan, such director or Section 16 Officer is (1) not aware of material nonpublic information about the company or its securities and (2) adopting the Rule 10b5-1 trading plan in good faith and not as part of a plan or scheme to evade the prohibitions of Rule 10b-5. The SEC noted that these certifications should serve as a reminder to directors and Section 16 Officers of their obligation to not trade or enter into trading plans while aware of material nonpublic information about a company or its securities, that it is their responsibility to determine whether they are aware of such information, and that the affirmative defense requires them to act in good faith. Most Rule 10b5-1 trading plans already include similar representations.

Restricting Multiple Overlapping Trading Arrangements and Single-Trade Arrangements

The new rules provide that the Rule 10b5-1 affirmative defense will not be available to persons, other than companies, who have, or subsequently enter into, any additional Rule 105b-1 trading plan, subject to the following exceptions:

- A person may enter into a series of separate contracts using different brokers to execute trades pursuant to a single Rule 10b5-1 trading plan that covers securities held in different accounts. These contracts may be treated as a single “plan,” provided that these contracts, when taken together as a whole, meet all of the applicable conditions of, and remain collectively subject to, the provisions of Rule 10b5-1(c)(1). Moreover, a modification of any such contract would be a modification of each other contract or instruction deemed to be part of the consolidated Rule 10b5-1 trading plan. Brokers may also be substituted for another as long as the instructions from broker to broker remain identical — if not, it may be deemed a termination of such Rule 10b5-1 trading plan and the adoption of a new Rule 10b5-1 trading plan, which would be subject to a new cooling-off period as noted above.

- A person also may maintain two separate Rule 10b5-1 trading plans at the same time provided that a later-commencing Rule 10b5-1 trading plan is not authorized to begin until after all trades under an earlier Rule 10b5-1 trading plan are completed or expire without execution. This exception is not available if the first trade under a later Rule 10b5-1 trading plan is scheduled during the “effective cooling-off period” or the cooling-off period that would be applicable to the later-commencing Rule 10b5-1 trading plan if the date of adoption of the

later Rule 10b5-1 trading plan was deemed to be the date of termination of the earlier-commencing Rule 10b5-1 trading plan. Both Rule 10b5-1 trading plans must meet the other conditions of the Rule 10b5-1 affirmative defense.

- For plans authorizing certain "sell-to-cover" transactions in which an insider instructs their agent to sell securities to satisfy tax withholding obligations at the time an award vests, an insider will not lose the benefit of the affirmative defense if such insider has another Rule 10b5-1 trading plan in place that would qualify for the affirmative defense, provided the additional plan(s) only authorize qualified sell-to-cover transactions. Such sell-to-cover plans are eligible for the affirmative defense regardless of whether the insider has another Rule 10b5-1 trading plan in place.

Lastly, consistent with the above approach for multiple overlapping plans, the SEC also adopted limitations on Rule 10b5-1 trading plans designed to cover a single trade, which will apply to Rule 10b5-1 trading plans of all persons, other than the company. Such single-trade plans will not benefit from the affirmative defense unless:

- The person who entered into the Rule 10b5-1 trading plan has not adopted another Rule 10b5-1 trading plan designed to effect the open-market purchase or sale of the total amount of securities subject to that Rule 10b5-1 trading plan in a single transaction during the prior 12-month period; and

- Such other Rule 10b5-1 trading plan was eligible to receive the affirmative defense.

The SEC clarified that a Rule 10b5-1 trading plan is "designed to effect" the purchase or sale of securities and a single transaction when it has the practical effect of requiring such a result. Conversely, a Rule 10b5-1 trading plan is not considered to be designed to effect the purchase or sale of securities as a single transaction when the Rule 10b5-1 trading plan does not leave discretion to the agent, but instead provides that the agent's future acts are contingent on events or data unknown at the time the Rule 10b5-1 trading plan is entered into, and it is reasonably foreseeable at the time the Rule 10b5-1 trading plan is entered into that it may result in multiple transactions. The SEC also included an exception to this restriction for qualified sell-to-cover transactions, similar to the exception discussed above for multiple overlapping Rule 10b5-1 trading plans.

Amended Good Faith Condition

Currently, the Rule 10b5-1 good faith requirement only requires that a Rule 10b5-1 trading plan be entered into in good faith. The new rules add a condition that the person who entered into the Rule 10b5-1 trading plan "has acted in good faith with respect to" the same. This amended good faith obligation applies to the activities of the insider (including efforts to direct the activities of others), and it extends this concept from the time of adoption through the duration of the Rule 10b5-1 trading plan. For example, an insider would not be operating a Rule 10b5-1 trading plan in good faith if the insider, while aware of material nonpublic information, directly or indirectly induces the company to publicly disclose that information in a manner that makes their trades under a Rule 10b5-1 trading plan more profitable (or less unprofitable). In such a scenario, notwithstanding that the Rule 10b5-1 trading plan may have been adopted or entered into in good faith, the insider would not be entitled to the affirmative defense.

Importantly, the SEC recently brought an enforcement action against executives for adopting Rule 10b5-1 trading plans not in good faith. In September 2022, the SEC announced charges against Cheetah Mobile, Inc.'s CEO and another executive for insider trading, even though the questionable trades occurred under Rule 10b5-1 trading plans adopted by the executives. The SEC's order found that the Cheetah Mobile executives established the Rule 10b5-1 trading plans only after the discovery of material nonpublic information that would later cause a drop in Cheetah Mobile's share price. Consistent with the federal securities laws, Cheetah Mobile's insider trading policy prohibited employees from establishing Rule 10b5-1 trading plans while in the possession of material nonpublic information. Because the SEC determined that the executives knew they had material nonpublic information at the time they adopted their Rule 10b5-1 trading plans, the SEC determined that the Rule 10b5-1 trading plans were ineffective and created in bad faith. While the Cheetah Mobile executives settled the action without admitting or denying the SEC's findings, such executives did agree to civil penalties and future trading restrictions.

Enhanced Disclosure Requirements

Item 408 of Regulation S-K and Related Form Changes

Previously, there were no mandatory disclosure requirements concerning either the use of Rule 10b5-1 trading plans by companies or directors or officers or a company's insider trading policies or procedures. New Item 408 of Regulation S-K will require a company (1) to disclose whether, during its last fiscal quarter (fourth fiscal quarter in the case of an annual report), any director or Section 16 Officer has adopted or terminated (i) any contract, instruction, or written plan for the purchase or sale of securities of a company intended to satisfy the affirmative defense conditions of Rule 10b5-1(c) (Rule 10b5-1 trading arrangement), and/or (ii) any written trading arrangement for the purchase or sale of securities of the company that meets the requirements of a non-Rule 10b5-1 trading arrangement as defined in Item 408(c) (Non-Rule 10b5-1 trading arrangement); and (2) to provide a description of the material terms of the Rule 10b5-1 trading arrangement or Non-Rule 10b5-1 trading arrangement other than terms with respect to the price at which the trading arrangement is authorized to trade, such as the:

- Name and title of the director or Section 16 Officer;
- Date of adoption or termination of the trading arrangement;
- Duration of the trading arrangement; and
- Aggregate number of securities to be sold or purchased under the trading arrangement.

For a trading arrangement subject to disclosure under Item 408, companies will be required to indicate whether such trading arrangement is a Rule 10b5-1 trading arrangement or is a Non-Rule 10b5-1 trading arrangement. In addition, any modification or change by a director or Section 16 Officer that is treated as a termination and adoption of a new Rule 10b5-1 trading arrangement or Non-Rule 10b5-1 trading arrangement would also be required to be disclosed under Item 408(a).

The SEC also adopted new Item 408(b), which will require a company to disclose whether it has adopted insider

trading policies and procedures reasonably designed to promote compliance with insider trading laws, rules, and regulations and any listing standards applicable to such company's securities. If a company has not adopted such insider trading policies and procedures, it must now explain why it has not done so in its annual report on Form 10-K and proxy and information statements. Item 16J of Form 20-F is the analogous requirement for disclosure by foreign private companies in their annual reports. Companies will be permitted to incorporate by reference the information required by Item 408(b) from a definitive proxy or information statement into their Form 10-K, subject to the Form 10-K Instruction G requirement that the proxy statement be filed within 120 days of fiscal year-end.

The new rules do not require disclosure of a company's policies and procedures within the body of the annual report or proxy/information statement. Instead, the SEC adopted amendments to Item 601 of Regulation S-K and Form 20-F to require companies to file a copy of their insider trading policies and procedures as an exhibit to Forms 10-K and 20-F.

Note that these new disclosure requirements will be subject to the certification requirements of Item 302 of Sarbanes-Oxley Act of 2002.

Enhanced Disclosure Regarding Option Grants and Similar Equity Instruments

New Item 402(x) of Regulation S-K will require additional narrative and tabular disclosures regarding practices related to awards of stock options, stock appreciation rights (SARs), and similar option-like instruments. Specifically, new Item 402(x) will require:

- Narrative disclosure discussing a company's policies and practices on the timing of awards of stock options, SARs, and/or similar option-like instruments in relation to the disclosure of material nonpublic information by a company, including how the board determines when to grant such awards.

- Narrative disclosure discussing whether, and if so, how the board or compensation committee takes material nonpublic information into account when determining the timing and terms of an award and whether the company has timed the disclosure of material nonpublic information for the purpose of affecting the value of executive compensation.

- Tabular disclosure regarding awards of options, SARs, and/or similar like instruments shortly before and immediately after the release of material nonpublic information. Specifically, if during the last completed fiscal year, such instruments were awarded to a named executive officer 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 disclosing material nonpublic information (including earnings information and other than a Form 8-K disclosure a material new option award grant under Item 5.02(e)), and ending one business day after a triggering event, a company must provide certain information concerning such award on an aggregated basis in the tabular format set forth in the new Item 402(x).

Inline XBRL Tagging Requirement

The new rules require companies to tag the information specified by new Items 402(x), 408(a), and 408(b)(1) of

Regulation S-K and Item 16J(a) of Form 20-F in Inline XBRL. Companies must comply with the Inline XBRL tagging requirements in Forms 10-Q, 10-K, and 20-F and any proxy or information statements that are required to include the Item 408 and/or Item 402(x) disclosures, beginning with the first such filing that covers the first full fiscal period beginning on or after April 1, 2023, for companies other than SRCs. SRCs will be required to provide and tag the disclosures beginning with the first such filing that covers the first full fiscal period beginning on or after October 1, 2023.

Section 16 Reporting Changes

The new rules provide amendments to Forms 4 and 5 to include Rule 10b5-1 checkboxes that indicate whether a reported transaction is pursuant to a plan "intended to satisfy the affirmative defense conditions" of Rule 10b5-1(c).

Further, Section 16 reporting persons will be required to report dispositions of bona fide gifts of equity securities on Form 4 (rather than Form 5) in accordance with the Form 4 filing deadline (*i.e.,* within two business days following the date of the gift). The SEC clarified that the Rule 10b5-1(c)(1) affirmative defense is available for any bona fide gift of securities carried out under a pre-arranged trading plan complying with the conditions of Rule 10b5-1, including a gift that might otherwise have subjected a donor to liability under Section 10(b).

Conclusion

The newly adopted amendments passed with unanimous support; all five commissioners issued statements supporting the amendments when the changes were proposed. One commissioner noted that the newly adopted amendments will close what they consider to be gaps in the current Rule 10b5-1 construct. Another commissioner stated that the amendments seek "to curb potential abuses of our rules and enhance transparency for investors, while not unduly restricting company and individual trading in a company's securities for foreseeable, appropriate purposes."

Companies should review and revise their insider trading policies and procedures to address the changes to Rule 10b5-1 trading plan requirements, as well as review and update their disclosure controls and procedures to ensure timely compliance with the enhanced disclosure requirements regarding Rule 10b5-1 trading arrangements, Non-Rule 10b5-1 trading arrangements, option grants, company insider trading policies, and procedures. In particular, updates to companies' disclosure controls and procedures should address the quarterly disclosure requirements related to the adoption, modification, or termination of 10b5-1 trading arrangements and certain other trading arrangements. Companies should also review their existing option grant practices and consider whether any changes are appropriate to, among other things, avoid any implication that the grants were timed to take advantage of material nonpublic information and being required to provide the related narrative and tabular disclosure. Section 16 Officers and directors should also familiarize themselves with the new Form 4 and Form 5 filing requirements and be sure to include the new checkbox when and as required on Forms 4 and 5 in future filings.

RELATED INDUSTRIES + PRACTICES

- Corporate
- Securities Litigation