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SEC Reaffirms 10b5-1 Plans Provide No Protection if Plans Not Established in Good Faith

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On September 21, the Securities and Exchange Commission (SEC) announced charges against Cheetah Mobile, Inc.'s CEO and former president for insider trading, even though the questionable trades occurred under a 10b5-1 trading plan. The SEC's order found that Cheetah Mobile's CEO Sheng Fu and its then-President and CTO Ming Xu established the trading plans only after the discovery of material nonpublic information that would later cause a drop in Cheetah Mobile's share price. Fu and Xu settled the action without admitting or denying the SEC's findings, agreeing to civil penalties and future trading restrictions. The SEC's action comes after officials voiced concerns about the potential abuse of 10b5-1 plans, and the SEC currently has a pending proposal to alter Rule 10b5-1 to curb these perceived abuses.

Cheetah Mobile is a China-based technology company focused on developing mobile games and other applications for smartphones whose American Depository Receipts (ADRs) trade on the NYSE. According to the SEC's order, Cheetah Mobile earned approximately one-third of its revenue from third-party advertisements provided by "an advertising division of a major social media platform" (Advertising Partner). In 2015, the Advertising Partner informed Cheetah Mobile changes to the algorithm used to determine fees paid for ad placements. This change to the algorithm could decrease the revenue Cheetah Mobile received from the Advertising Partner by up to 50%. After Cheetah Mobile failed to implement platform changes that would boost revenue under the new algorithm in early 2016, revenue began to decline. Rather than disclose this, however, Cheetah Mobile hid the downward revenue trend from investors.

At the same time, Fu and Xu established 10b5-1 trading plans for selling some of their holdings in Cheetah Mobile. By the time Cheetah Mobile disclosed lower-than-expected revenue for second quarter 2016, Fu and Xu had sold more than 96,000 shares, avoiding losses of $203,290 and $100,127, respectively, under such plans. Consistent with the federal securities laws, Cheetah Mobile's insider trading policy prohibited employees from establishing 10b5-1 plans while in the possession of material nonpublic information. Because Fu and Xu knew they had material nonpublic information at the time they created the trading plans, the SEC determined that the 10b5-1 plans were ineffective and created in bad faith, subjecting Fu and Xu to liability for securities fraud. Additionally, the SEC found Fu and Xu in violation of Section 10(b) and Rule 10b-5 thereunder for the trades made on the basis of material nonpublic information.

The SEC's actions in this case signal the agency's continued focus on abuses relating to 10b5-1 trading plans, and in particular, the agency's efforts to combat the perception that 10b5-1 plans create a vehicle for legalized insider trading. While 10b5-1 trading plans provide a useful tool to protect corporate insiders' ability to trade a company's securities for legitimate purposes, plans created while in possession of material nonpublic information provide no such protection. Issuers and individuals contemplating entering into or modifying 10b5-1 plans should carefully evaluate their knowledge and factual background before implementing any plan, otherwise the SEC may assert violations of the federal securities laws for any subsequent trades.

Please contact any Troutman Pepper Securities Investigations + Enforcement team member to assist your company in preparing or enhancing your 10b5-1 plans.

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