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THE SEC'S NEW 10B5-1 RULES AND EMERGING INSIDER TRADING POLICY BEST PRACTICES

In this article, the authors explain recently adopted amendments to Rule 10b5-1 and related disclosure rules, and share insights into best practices that have emerged as companies update existing insider trading policies as a result of the new rules.

By Michael L. Arnold and Lisa M. Kohl *

On December 14, 2022, the Securities and Exchange Commission (the "SEC" or the "Commission") adopted final rules (the "Final Rules")[1] which add a number of new requirements to Rule 10b5-1 that significantly limit the availability of the affirmative defense provided by that rule to violations of Section 10(b) of the Securities Exchange Act of 1934 (the "Exchange Act") and Rule 10b5-1 thereunder. The Final Rules also include new disclosure requirements that will require public companies (1) to describe and file their policies and procedures related to insider trading ("ITP"); (2) to provide additional narrative disclosure about compensatory incentive awards in certain situations; and (3) on a quarterly basis, to disclose information about the use of Rule 10b5-1 plans and other trading arrangements by their officers and directors. The Final Rules also add a mandatory check box to Forms 4 and 5 requiring insiders who must file those reports to indicate whether the reported transaction is pursuant to a plan intended to satisfy the Rule 10b5-1 affirmative defense and requires bona fide gifts of securities to be reported on Form 4 in accordance with that form's filing deadline. In response to the Final Rules, many companies have taken the opportunity to revisit their ITPs, with a particular focus on a set of emerging issues and best practices.[2]

NEW CONDITIONS TO THE RULE 10B5-1 AFFIRMATIVE DEFENSE

The Final Rules add a number of new conditions to the Rule 10b5-1 affirmative defense, including new mandatory cooling-off periods, limits on overlapping and single-trade plans, required good faith representations, and an "acted in good faith" requirement.

[1] Insider Trading Arrangements and Related Disclosures, Release No. 34-96492 (Dec. 14, 2022). The text of the final rule and the Commission's related adopting release (the "Adopting Release") can be found on the SEC's website *at* https://www.sec.gov/rules/final/2022/33-11138.pdf.

[2] This article focuses on the Final Rules and related best practices as they pertain to domestic companies and does not discuss how foreign private issuers are affected by the Final Rules.

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Cooling-Off Periods

Directors and officers (as defined in Rule 16a-1(f))[3] must now include in any new Rule 10b5-1 plan a cooling-off period that extends until the later of: (1) 90 days after the plan is adopted and (2) 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 is adopted, with a maximum required cooling-off period of 120 days after adoption of the plan. Notably, the Commission stated in the Adopting Release it had considered tying the end of the directors' and officers' cooling-off period to the filing of an issuer's earnings release under Item 2.02 of Form 8-K, but expressly determined that was inadequate and that the filing of the periodic report was a more appropriate endpoint. All persons other than directors, officers, or issuers must include a 30-day cooling-off period in any Rule 10b5-1 plan.[4] Importantly, under the Final Rules, modifications described in new Rule 10b5-1(c)(1)(iv), which include changes to the amount, price or price range, or timing of purchases or sales, will constitute the termination of an existing plan and the adoption of a new plan. This means that any modification to the amount, price or price range, or timing of purchases or sales will trigger a new cooling-off period for persons other than the issuer.[5]

Limits on Overlapping and Single-Trade Plans

In addition to the new cooling-off periods, the Commission imposed new limitations on the use of overlapping and single-trade plans. Under the Final Rules, persons other than the issuer may have only one Rule 10b5-1 plan outstanding at a time, with limited exceptions for:

- A new Rule 10b5-1 trading plan under which trades do not begin until sales under the earlier plan are complete or expire without execution.[6]
- Plans authorizing "sell-to-cover" transactions to satisfy tax withholding obligations incident to the vesting of certain compensatory awards such as

[3] The officers that will be required to comply with the provisions of the affirmative defense applicable to directors and officers include a company's president, principal financial officer, principal accounting officer (or, if there is no such accounting officer, the controller), vice president of the company in charge of a principal business unit, division or function (such as sales, administration or finance), and any other officer who performs a policy-making function or any other person who performs similar policy-making functions for the company, i.e., the officers who are required to file Form 4s.

[4] When the Commission initially proposed these amendments to Rule 10b5-1, many of the new conditions would have applied to the issuer, as well as to officers and directors. Under the Final Rules, only the "acted in good faith" requirement applies to issuers.

[5] The Adopting Release states that "modifications that do not change the sales or purchase prices or price ranges, the amount

footnote continued from previous column…

of securities to be sold or purchased, or the timing of transactions under a Rule 10b5-1 plan (such as an adjustment for stock splits or a change in account information) will not trigger a new cooling-off period."

[6] However, the affirmative defense will only be available in this scenario if an insider does not modify or terminate the earlier Rule 10b5-1 plan in a way that would operate to shorten the required cooling-off period for the later-adopted plan. The Adopting Release provides this example:

"An insider who is not an officer or director has in place an existing Rule 10b5-1 plan with a scheduled date for the latest authorized trade date of May 31, 2023. On May 1, 2023, that insider adopts a later-commencing plan, intended to qualify for the affirmative defense under Rule 10b5-1, with a scheduled date for the first authorized trade of June 1, 2023. If the insider terminates the earlier-commencing plan on May 15, the later-commencing plan will not receive the benefit of the affirmative defense, because June 1 is within 30 days of May 15, the date of termination of the earlier-commencing plan, and thus June 1 is during the 'effective cooling-off period.' However, if the later-commencing plan were scheduled to begin trading on July 1, 2023, it could still receive the benefit of the affirmative defense because July 1, 2023 is more than 30 days after May 15 and thus outside the 'effective cooling-off period.'"

restricted stock or stock appreciation rights, so long as the plan holder does not otherwise exercise control over the timing of such sales.[7]

With respect to single-trade plans for persons other than the issuer, the affirmative defense will only be available for one single-trade plan in a consecutive 12-month period.[8] The SEC considers a trade to be a single-trade plan if it is "designed to effect" a trade in a single transaction. Plans that may give a broker discretion over sales or tie triggers to several different stock prices will not be deemed single-trade plans, even if they happen to execute only in a single trade.

"Acted in Good Faith" Requirement

The affirmative defense will only be available if a person, including issuers, directors, officers, and other insiders, have "acted in good faith" with respect to the Rule 10b5-1 plan. This new condition to the affirmative defense is intended to deter an insider from influencing the timing of disclosures to benefit trades scheduled under the insider's Rule 10b5-1 plan. For example, delaying the release of negative information until after scheduled sales have occurred under a plan could call into question whether the insider acted in good faith with respect to the operation of the plan. Additionally, the Adopting Release notes an insider would not be acting in good faith if he or she "directly or indirectly induces the issuer to publicly disclose . . . information in a manner that makes their trades under a Rule 10b5-1 plan more profitable (or less unprofitable)."

The new condition is intended to focus on the activities of a particular person, so issuer-imposed cancellations and blackout periods that are *outside of an individual's control or influence* should not implicate the "act in good faith" condition of that particular individual. However, directors and officers would be well-advised to be cautious about how their positions in internal deliberations around disclosure decisions may be perceived with the benefit of hindsight, and issuers should similarly be mindful of how any planned issuer 10b5-1 activity will be perceived.

Good Faith Plan Representation

Finally, the Final Rules require that officers and directors include in any plan a representation certifying that at the time of the adoption of a new or modified Rule 10b5-1 plan: (1) they are not aware of material non-public information about the issuer or its securities and (2) they are adopting the plan in good faith. Unlike the proposal, the required representation must only be included in the plan documentation and not provided separately to the company.

NEW DISCLOSURE REQUIREMENTS

In addition to the new conditions to the availability of the Rule 10b5-1 affirmative defense, the Final Rules added new Items 408 and 402(x) of Regulation S-K. New Item 408(a) of Regulation S-K will require quarterly disclosure of the material terms, other than price-related information, of any Rule 10b5-1 plan or similar trading arrangement that directors or officers entered into or terminated during the preceding quarter. Companies will also be required to disclose whether each plan disclosed is a Rule 10b5-1 plan or a "non-Rule 10b5-1 trading arrangement."[9] Companies other than

[7] In light of the discretion involved in deciding when to exercise options, option exercises and their related sales are not included in this limited exception.

[8] If a person enters into a single-trade plan that is not intended to qualify for the affirmative defense in Rule 10b5-1(c), the affirmative defense will remain available for one single-trade plan that is intended to qualify.

[9] Requiring disclosure about "non-Rule 10b5-1 trading arrangements" is designed to deter directors and officers from choosing to rely on defenses other than Rule 10b5-1 to avoid providing the new Item 408 disclosures. For the purposes of Item 408, a "non-Rule 10b5-1 trading arrangement" is one where:

(1) The covered person asserts that at a time when they were not aware of material nonpublic information about the security or the issuer of the security, they had adopted a written arrangement for trading the securities; and

(2) The trading arrangement:

(i) 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 purchased or sold;

(ii) included a written formula or algorithm, or computer program, for determining the amount of securities to be purchased or sold, and the price and the date on which the securities were to be sold; or

(iii) 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 material non-public information while doing so.

smaller reporting companies ("SRCs") will be required to provide Item 408(a) disclosure in the first quarterly report that covers the full fiscal period that begins on or after April 1, 2023.[10] For calendar year-end filers, this means the disclosure will first be required in Form 10-Q for the fiscal period ending June 30, 2023.

Item 408(b) will require companies to disclose on an annual basis whether the company has policies and procedures governing the purchase, sale and/or other dispositions of the company's securities by directors, officers, and employees, or the registrant itself reasonably designed to promote compliance with insider trading laws, rules, regulations, and any listing standards applicable to the company. If so, the applicable ITPs must be filed as an exhibit to the company's annual report. If the company has not adopted such policies and procedures, it must explain why it has not done so. Although the relevant transition period section of the Adopting Release is open to multiple plausible readings, representatives of the SEC staff have publicly clarified that companies other than SRCs will be required to provide the Item 408(b) disclosure in the annual report that covers the entire fiscal year beginning on or after April 1, 2023. This means that for calendar year-end filers the disclosure (including filing their ITPs as exhibits) will first be required in the Form 10-K for the fiscal year ended December 31, 2024, and related proxy statement, each to be filed in 2025.

Item 402(x) will require additional narrative and tabular disclosure about a company's policies and practices related to the grant of certain equity awards close in time to the release of material non-public information. More specifically, the new tabular disclosure must include any stock options, SARs, or similar instruments awarded to a named executive officer within the last completed fiscal year that were awarded in the period between (1) four business days before the filing of a periodic report, or the filing or furnishing of a current report that discloses material non-public information and (2) one business day after the filing or furnishing of such report. In addition to the required tabular disclosure, Item 402(x) will require new narrative disclosure about (1) how the board determines when to grant awards, (2) whether and how the compensation committee takes material non-public information into account when determining the timing and award terms, and (3) whether a company has timed the disclosure of material non-public information for the purpose of affecting the value of the compensation. Companies will first be required to provide Item 402(x) disclosure in the annual report that covers the entire fiscal year beginning on or after April 1, 2023. For calendar year-end filers, this means the disclosure will first be required in the Form 10-K for the fiscal year ended December 31, 2024, and related proxy statement, each filed in 2025.

Finally, the Commission also amended certain rules related to the filing of beneficial ownership reports under Section 16. Reporting persons are now required to report bona fide gifts of securities within two business days of the transaction, rather than annually on Form 5 as previously permitted. The Commission also added new check boxes to Forms 4 and 5 that will require Section 16 reporting persons to indicate by checkbox whether a reported transaction was intended to satisfy the Rule 10b5-1(c) affirmative defense and to disclose in the Form 4 or Form 5 the date the trading plan was adopted. Insiders must comply with the new Form 4 and Form 5 checkbox requirements in Section 16 reports filed on or after April 1, 2023, although the requirement to report gifts on the existing Form 4 became effective in late February.

EMERGING BEST PRACTICES

The Final Rules were effective on February 27, 2023, and although the new Item 408 and 402(x) disclosure requirements (including the public disclosure of ITPs) are not yet mandatory, the changes to Rule 10b5-1 are now effective and any new Rule 10b5-1 plan must comply with the amended rule and new conditions to qualify for the affirmative defense. As noted above, gifts must also now be reported on Form 4. Prompted by the Final Rules, including both their substantive requirements and the knowledge that disclosure of the company's ITP will eventually be required, many companies are revisiting their ITPs in light of the Final Rules. There are a number of areas in which best practices in updating ITPs are beginning to emerge, as described below.

Implementing the Final Rules

Companies and their counsel should consider the following in determining updates to their ITPs to implement the mechanical requirements of the Final Rules.

- *Updates to Reflect the New Rule 10b5-1 Conditions* — As a threshold matter, as noted above, there are a number of new conditions to the use of the Rule 10b5-1 affirmative defense that may need to be

[10] SRCs must first provide Item 408(a) disclosure in the first quarterly report that covers the first full quarter that begins on or after October 1, 2023.

reflected in a company's ITP. The scope of the required changes will be determined by the approach in the company's existing ITP to the description of Rule 10b5-1. Some policies may refer to Rule 10b5-1 in a high-level, "evergreen" manner — that is, the ITP simply references Rule 10b5-1 without describing the underlying requirements and conditions which were affected by the Final Rules. While no changes may be strictly necessary for these types of ITPs, these ITPs provide less notice and explanation of the relevant Rule 10b5-1 requirements to directors and officers reviewing the ITPs, meaning internal legal teams will need to do more to explain the requirements outside of the ITPs themselves. Because the Final Rules contain significantly more prescriptive conditions to the availability of the Rule 10b5-1 defense, companies with these high-level evergreen references to Rule 10b5-1 may wish to revise their ITP to provide at least some detail about the conditions to the use of the Rule 10b5-1 affirmative defense to provide clarity and context for insiders. Conversely, companies with ITPs that already provide full recitations of the requirements of Rule 10b5-1 may find themselves needing to provide extensive and detailed updates to descriptions to align with the Final Rules. Companies with these types of ITPs may find that somewhat abbreviated, summary references to the most technical conditions (such as provisions around overlapping plans, or the modification of plans) may suffice instead of comprehensive summaries. Companies preparing new ITPs or incorporating Rule 10b5-1 provisions into ITPs for the first time may find that the "Goldilocks approach" to describing Rule 10b5-1 is best: a sufficiently detailed description to provide insiders with a description of the rule's general requirements but without the technical description that provides unnecessary detail.

- *Gifts* — The Final Rules reflect a continued SEC focus on gifts of securities, and the Adopting Release identifies gifts of securities as a type of disposition where material nonpublic information could be misused, noting that the Exchange Act does not require that a "sale" of securities be for value.[11] While prior to the Final Rules it had been an ideal practice to cover gifts of securities in an ITP in some way, any company that does not currently cover gifts in their ITP should seriously consider amending their ITP to do so. Gifts can be addressed in different ways. The first is to treat gifts in exactly the same way as other dispositions of company securities and subject them to all of the conditions applicable to sales. While the cleanest solution to draft and administer, and the one most consistent with the SEC's theory of "insider gifting" articulated in the Adopting Release, this approach is also the most prescriptive potential treatment and most likely a deviation from the company's existing practices. Alternatively, unlike sales, gifts may be allowed during a blackout period subject to additional conditions (such as any person gifting securities to obtain express agreement from the donee that the donee will not sell the gifted securities while the insider donor is in possession of material nonpublic information). The Adopting Release notes the SEC expressly declined to adopt this type of construct in its crafting of the requirements of the Final Rules, but ultimately both of these approaches should address recent SEC concerns with respect to gifts, at least in the absence of more clear caselaw applying insider trading law to gifts. In addition to covering gifts generally in a company's ITP, because gifts now must be reported on Form 4, companies should also work to establish processes to ensure that gifts are reported in real-time to those responsible for Section 16 filings, such as by requiring pre-clearance or notice of gifts to in-house counsel several days in advance of any gift.

- *Application of the ITP to the Company* — As described above, Item 408(b) of Regulation S-K will require companies to disclose whether they have ITPs applicable to the company's own trading in its securities and to file those ITPs as an exhibit to the company's annual report for any fiscal year that starts after April 1, 2023. If a company does not have an ITP covering its own trading activity in company securities, the company must disclose that fact and explain why not. Most ITPs have not historically covered the company's own trading activity, but many companies are now revising their ITPs to cover such activity to avoid making what may be an embarrassing Item 408(b) disclosure. In many cases, the company will want to revise the ITP to make clear that it covers the company's own trading activity but will want to do so in a targeted way that does not subject the company to many standard provisions of the ITP that only make sense when applied to individuals (such as complicated pre-clearance procedures, or the Rule 10b5-1 requirements applicable to individuals rather than issuers).

[11] *See* Adopting Release at footnote 257 and accompanying text.

General Best Practices

As noted above, companies will soon be required to file their ITPs as an exhibit to their annual filings pursuant to Item 408(b) of Regulation S-K. Once ITPs are filed, we believe it is likely that investors, proxy advisors, and others will review ITPs and scrutinize companies with ITPs that are noticeably more permissive than those of peer companies. Accordingly, as companies update their ITPs in light of the Final Rules, companies would be well-advised to consider whether any other updates are warranted to bring the ITP up to industry or market standard, particularly with respect to:

- *Blackout Period Duration* — Companies should consider whether the ITP includes appropriate blackout periods applicable to some or all covered persons preceding and following the release of quarterly results. Companies with no blackout periods or blackout periods that are particularly short should consider moving to a more standard blackout period, which will typically commence two to three weeks before the end of the quarter and end one to two trading days after results are released. While the required cooling-off period for Rule 10b5-1 plans is tied to the filing of the relevant Form 10-K or Form 10-Q, many ITPs have insider trading blackout periods aligned to the earlier publication of the applicable earnings release. Although updates to this construction are not necessarily required at this point, this may ultimately be an issue which draws future investor scrutiny following the wider publication of ITPs.

- *Hedging, Pledging, or Speculative Trading Activities* — It is generally a best practice to prohibit or strictly limit directors and officers from engaging in hedging transactions, pledging company securities, or otherwise engaging in speculative trading activity. While some companies may be comfortable with the risk presented by some or all of these activities within certain limits and applicable law, these activities are already a hot-button for investors and proxy advisory firms, meaning they are likely to be a point of particular focus once ITPs are publicly available. Companies updating their ITPs should consider defining in some detail the scope of any such restricted activity and narrowly tailoring any permissions on these topics they do allow. Common limitations in ITPs include restrictions on short-term trades; short sales (keeping in mind additionally the legal requirements of Section 16(c) of the Exchange Act); transactions in exchange-traded options; hedging transactions; margin loans and the pledging of securities (sometimes prohibiting it entirely or only subject to a cap); and placing standing or limit orders (outside of an approved Rule 10b5-1 plan).

- *Covered Persons, Trades, and Procedures* — Companies should consider whether the scope of its current ITP is appropriate on a number of additional dimensions. For example, in light of the Final Rules, companies may wish to revisit whether their ITP applies to contractors or consultants with access to material nonpublic information, instead of just employees or directors, to avoid being seen by investors as having lax procedures around these types of individuals. Additionally, given recent legal developments, it is now a standard practice to cover trading in other companies' securities if the insider obtains material nonpublic information about another company in the course of its employment or other relationship with the company. Companies may also wish to refresh the types of transactions that are exempted from the ITP, since there are many types of ordinary course transactions that may seem to potentially implicate insider trading law, but are ultimately acceptable to permit (particularly with respect to certain elections or vesting events around incentive awards). Finally, companies may not want to be perceived as unduly lax in their application of heightened procedures such as blackout periods or pre-clearance requirements. The appropriate depth within the company to impose blackout periods and pre-clearance requirements depends on the nature of the company's operations (such as how deep within the company it can be assumed that an employee may come into possession of material non-public information or the company's process for preparing SEC filings or other documents).

CONCLUSION

The amendments to Rule 10b5-1 represent a significant change to the insider trading landscape and much remains to be seen about how insider and company practices will develop in response to the amendments. We expect that companies will continue to examine and refine their ITPs in light of the new rules, especially with respect to the topics covered above, as they gain experience with revised Rule 10b5-1 and in anticipation of the new disclosure requirement. ■