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SEC Proposes Amendments to Rule 10b5-1 and New Rules for Disclosure of Issuer Share Repurchases

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On December 15, 2021, the Securities and Exchange Commission (the "SEC" or the "Commission") held an Open Meeting at which the commissioners agreed to issue a number of rule proposals for public comment. These included proposed amendments to Rule 10b5-1 and the affirmative defense it provides against charges of insider trading, as well as new rules governing public companies' disclosures when engaged in share repurchases (or "stock buybacks"). The set of proposals addressing Rule 10b5-1 also includes changes to Form 4 (which insiders must file to report their transactions in issuer securities), new requirements that companies disclose the substance of their insider trading policies and new disclosure about compensatory incentive awards. The new issuer repurchase disclosure rules would, if adopted, create a new form and mandate much more detailed and timely disclosure about repurchases than currently required in periodic reports. In this alert, we summarize the new proposed rules and offer some additional observations, including identifying some key areas of uncertainty that may be addressed in final rules.

RULE 10b5-1

Rule 10b5-1 was adopted by the SEC in 2000 to provide an affirmative defense against charges of insider trading when transactions in the company's stock are executed at times that the insider may be in possession of material nonpublic information. In the 20 years since the rule was adopted, various SEC commissioners, academics and institutional investors have raised alarms that, despite the requirement for plans to be entered into in good faith, insiders have nonetheless been able to abuse the rule and reap outsized profits (or avoid losses) on trades in their companies' securities. Recent papers studying insider shareholder returns and the timing of gifts have made this an issue of significant current academic focus. Notwithstanding these concerns, however, SEC enforcement actions against alleged abuses of Rule 10b5-1 trading plans have been essentially nonexistent and private plaintiffs have met with limited success as well.

Tightening the Affirmative Defense

The proposed amendments to Rule 10b5-1 would further limit the availability of the rule's affirmative defense by:

- imposing a mandatory cooling-off period between the date of adoption of any Rule 10b5-1 trading plan and the start of trades pursuant to the plan (proposed to be 120 days for officers and directors and 30 days for issuers structuring a share repurchase plan under Rule 10b5-1(c)(1)(i));

- requiring written certification by officers and directors indicating they are not aware of material nonpublic information about the issuer or its securities when adopting a Rule 10b5-1 trading plan and have adopted such plan in good faith (we understand that most broker-dealers already require such representations from officers and directors when entering into Rule 10b5-1 trading plans with them);
- prohibiting multiple overlapping trading plans for purchases or sales of the same class of securities;
- allowing during any 12-month period only one "single-trade" plan (*i.e.*, a plan directing only a single trade, which academic studies suggest may be particularly prone to abuse); and
- requiring that a trading plan be not only entered into but also "operated" in good faith.

New Disclosure Requirements About 10b5-1 Plans, Trades and Issuers' Insider Trading Policies

The SEC has also proposed enhanced disclosure requirements regarding the use of Rule 10b5-1 trading plans. In their periodic reports on Forms 10-Q and 10-K, companies would be required to disclose whether the company or any director or officer has adopted or terminated any Rule 10b5-1 trading plan (or other similar trading contracts) during the period covered by the report.

Additionally, companies would need to disclose whether the company has adopted an insider trading policy. Registrants would be required to disclose such policy in their proxy and information statements on Schedules 14A and 14C and in their annual reports on Form 10-K or, in the case of foreign private issuers, Form 20-F. If the registrant has not adopted an insider trading policy, it would be required to disclose why it has not (which as a practical matter means that every company will now adopt such a policy).

For those insiders required to file reports of their stock transactions pursuant to Section 16, the insiders would need to disclose in their Forms 4 and 5 whether the sale or purchase reported was made pursuant to a Rule 10b5-1 trading plan. Filers would also need to report any bona fide gifts of securities on Form 4 by the end of the second business day after the transaction (currently, insiders may report gifts on Form 5, which is not due until 45 days after the company's fiscal year end).

Finally, the Commission has proposed new disclosure rules around compensatory incentive grants. Since the significant revision of its executive compensation disclosure rules in 2006, the SEC has been concerned about potentially abusive timing of incentive awards granted to executive officers including "spring-loading" (when incentive grants are timed to occur immediately before the release of positive material nonpublic information) and "bullet-dodging" (when incentive grants are timed to occur after the release of negative material nonpublic information). In its rulemaking release in 2006, the Commission had noted that the existence of a program, plan or practice to select equity grant dates for executive officers in coordination with the release of material nonpublic information would be material to investors and should be fully disclosed, but the Commission has been dissatisfied with registrants' disclosure in the intervening years since those rules were adopted. To address its concerns in this space, the Commission has proposed to amend Item 402 of Regulation S-K to mandate tabular disclosure in annual reports and proxy statements of:

- each equity award (including the number of securities underlying the award, the date of grant, the grant date fair value and the exercise price, if applicable) granted within 14 calendar days before or after the filing of a periodic report, an issuer share repurchase or the filing or furnishing of a current report on Form 8-K that contains material nonpublic information;
- the market value of the securities underlying the award (*i.e.*, number of securities underlying award multiplied by closing market price) on the trading day before disclosure of the material nonpublic information; and
- the market value of the securities underlying the award on the trading day after disclosure of the material nonpublic information.

As currently proposed, these new disclosure requirements would apply to all public companies, including smaller reporting companies and emerging growth companies.

Additional Observations

The proposed amendments to Rule 10b5-1 and related rules signal the SEC's increased focus on preventing the abuse of material nonpublic information and closing the gaps within its regime to curtail insider trading. Preventing and punishing insider trading is a matter that commissioners of both political parties can easily support, and these proposals were passed unanimously at the Open Meeting, an increasingly rare result in recent years. We believe it is unlikely that the current proposal will change significantly following the comment period, which closes a short 45 days after the proposal is published in the Federal Register. Two commissioners, Hester Peirce and Elad Roisman, however, did express some reservations about the specifics of the proposals and about the short comment period, and we anticipate that the Commission will give due consideration to comments it receives, including on areas of ambiguity in the proposals, such as:

- **The practical operation of the mandatory cooling-off period**. The proposal is relatively simplistic, requiring a cooling-off period after any adoption or modification of a plan. This leaves open questions about what happens in certain common factual scenarios. For example, if the established trading instructions would result in no transactions once the cooling-off period ends (which can occur if scheduled trading prices are out of the money), insiders may find themselves in a difficult position. The current proposed amendment explicitly states that any modification of a trading plan would constitute the termination of the plan and the entry into a new plan, resulting in a new mandatory cooling-off period. If this is the intended result, insiders and companies will need to be especially thoughtful in setting up the terms of their plans to ensure appropriate functioning even in the event of significant moves in stock prices over the course of 120 days.
- **Operated in good faith**. The proposal requires a trading arrangement to be "operated" in good faith, expanding the existing requirement that the plan be "entered into" in good faith. While the proposed amendment provides examples where cancelling or modifying a plan would bar the affirmative defense, it remains to be seen whether the affirmative defense can apply if plans are canceled or modified for benign reasons. For example, plans may be adjusted to prevent bad optics or for other commendable corporate purposes, such as having an insider step out of the market while the company is engaged in negotiations over a transformative business transaction or to avoid a significant sale in advance of an unexpected, unannounced negative event (*e.g.*, a cyber breach at the company that has just been discovered). Even if issuers and insiders are confident in the motivations for their actions, they may be unwilling to take the risk their actions will be found to not be "operating" the trading arrangement in good faith, given the vagueness of this requirement.
- **Other arrangements**. Issuers, directors or officers will not just be required to disclose Rule 10b5-1 trading arrangements, but will also be required to disclose any "contract, instruction or written plan for the purchase or sale of securities" ("non-Rule 10b5-1 trading arrangements"). The proposed rules do not provide any examples of what "non-Rule 10b5-1 trading arrangements" are intended to capture (as drafted the language would appear to include any purchase or sale through a broker) or the rationale for requiring such disclosure, and we anticipate that this element of the proposal may be the subject of comments during the comment period.

ISSUER SHARE REPURCHASES

The proposed new rules on disclosures for issuer share repurchases would require issuers to produce a new "Form SR" which would need to be furnished (not filed) by the end of the first business day after the issuer has repurchased shares and would need to disclose details, including price and volume as well as timing of the issuer's repurchase, along with:

- the objective and rationale of share repurchases, as well as the process or criteria used to determine the amount of repurchased shares, policies and procedures relating to purchases or sales of the issuer's securities by officers and directors during a repurchase program and whether repurchases were made pursuant to the Rule 10b5-1 affirmative defense or in reliance on the Rule 10b-18 safe harbor; and
- if an officer or director purchased or sold any securities of the class of the issuer's securities that is the subject of the repurchase program within 10 business days before or after the announcement of such program.

Additional Observations

- It remains to be seen how much practical administrative burden is introduced by the Form SR requirements. Many issuers set up repurchase plans with broker-dealers that may span several days or weeks. On the face of the proposed rules, an issuer would need to furnish individual Forms SR for each day on which shares were repurchased. We expect the timing and potential burden of this requirement to be an area of frequent comment on the new proposal.
- The proposed rules refer to the fact that issuers may repurchase equity securities through accelerated share repurchase ("ASR") programs. In a standard ASR, an issuer makes an upfront payment to a financial institution counterparty and the counterparty delivers an initial number of the shares that counterparty has borrowed from existing shareholders in the institutional stock loan market. Throughout the term of the ASR, the counterparty purchases shares in the open market and returns those shares to the lending institutions. The ultimate number of shares to be purchased or the per-share purchase price may not be known until the conclusion of the transaction, which may result in uncertainty as to Form SR compliance.
- The proposal passed along party lines with a 3-2 vote in favor of the proposal, with Commissioners Peirce and Roisman dissenting. While Commissioner Peirce opposed as a general principle disclosure requirements as a means to indirectly regulate corporate activity, Commissioner Roisman took narrower issue with the timing of the proposed disclosure, suggesting instead that disclosure prior to the share repurchase would be a better solution to information asymmetry. While we expect a final rule on buybacks to be passed, there is some possibility that the final rule may be changed in response to comments on the extent of necessary disclosure and the timing of such disclosure.

NEXT STEPS

The comment period for the proposed amendments to Rule 10b5-1 and related new rule proposals around insider trading disclosures will run 45 days after the proposal has been published in the Federal Register. The comment period for the proposal for new rules relating to disclosure of company share repurchases will also run 45 days after Federal Register publication of that proposal.

We intend to provide comments to the SEC on the proposed rules and will closely monitor the final rules for how they address points raised by commenters, as the answers may inform appropriate best practices to be adopted by both issuers and insiders.

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