Davis Polk

You'd better watch out! New rules for company and insider stock transactions are coming to town

December 20, 2021 | Client Update | 17-minute read

The SEC's proposals include cooling-off periods for Rule 10b5-1 trading plans, public disclosure around Rule 10b5-1 trading plans, significant new disclosures for option grants and stock gifts, and daily reporting of stock buybacks.

On December 15, the Securities and Exchange Commission proposed new rules focused on stock and option transactions involving companies and their directors and officers, or "insiders." The proposals address concerns that have received on-and-off political, media and academic notice over the years but generated remarkably little SEC enforcement attention, suggestive of problems that are perhaps more apparent than real. Indeed the proposals seem tinged with the conviction that stock transactions by companies and insiders are inherently suspect. While some aspects of the proposals are already common practice, others may prove problematic or give the plaintiffs' bar new arrows in its quiver.

That said, as we discussed in a September 3, 2021 client update, action on these topics has been expected for several months and the SEC is likely to move quickly to finalize rules modeled on last week's proposals after an unusually short public comment period that will expire in mid-February 2022.

When approved, the requirements will apply to a variety of everyday practices, and so public companies should soon take steps to ensure their policies and procedures facilitate compliance. The proposals include:

- Amendments to Rule 10b5-1, the SEC rule many companies and insiders rely upon when buying and selling stock,
- Amendments to the rules governing disclosure of stock option grants,
- Amendments to Forms 4 and 5, which insiders use to report stock trades and gifts, and
- New reporting requirements for company buybacks, whether or not conducted according to a Rule 10b5-1 trading plan or the commonly used Rule 10b-18 safe harbor.

Proposed changes impacting Rule 10b5-1 trading plans

Rule 10b5-1, unveiled more than two decades ago, offers a defense to the charge of illegal insider trading for securities transactions executed according to a plan entered into when the trader does not have material nonpublic information, or "MNPI," about the company. Because they frequently hold MNPI, directors, officers and other company insiders often use Rule 10b5-1 trading plans to sell and buy stock, and companies themselves often use the plans when conducting stock buybacks. Properly used, Rule 10b5-1 trading plans help companies and insiders avoid running afoul of insider trading laws when engaging in everyday stock transactions. Nevertheless, over the years academic studies and investigative journalists have suggested that some insiders may use Rule 10b5-1 trading plans for the opposite purpose: to facilitate illegal insider trading. Although the SEC's enforcement program has never uncovered a wide pattern of such abuse, the SEC is proposing six major reforms to make sure it doesn't happen.

Copyright 2021 Davis Polk & Wardwell LLP

– **Mandatory cooling-off periods**. Though not required by the current rule, many companies require a cooling-off period between execution of a Rule 10b5-1 trading plan and the first trade under the plan, and we have long recommended a cooling-off period for insider plans in order help the insider demonstrate that they were not motivated to make trades by nonpublic information known at the time of plan adoption. The SEC's proposal would require a 120-day cooling off period for insider plans and a 30-day cooling-off period for company buyback plans, in each case triggered by plan adoption, modification or amendment (whether or not ministerial in nature, and likely including a temporary suspension or a change of broker).

  - *Insider trading plans*. We understand the rationale for applying cooling-off periods to insider trading plans, though we believe that a strict 120 days is longer than necessary. Provided a plan is entered into in an "open window," it usually should be enough to wait at most until the next earnings release in order to avoid the potential or appearance of trading on the basis of undisclosed information, which depending on the company and when the plan is adopted could be well short of 120 days.
  - *Company buyback plans*. What is harder to understand is the basis for a 30-day cooling-off period for company buybacks—a requirement that would in some cases be too short to matter, but in most cases would be unnecessarily long and therefore needlessly limit a company's flexibility. Many companies today have no cooling-off period for stock buybacks even though they impose them on insiders, reasoning that the company itself is well-positioned to make the call of whether or not it holds MNPI and also taking account of the differing risk profiles of company purchases and insider sales. But if a company did in fact have MNPI—for example, knowledge that the current quarter was going to strongly exceed stock market expectations—imposing a 30-day delay on trades would not necessarily ensure that the valuable information would be in the market before the first trade.

    Any mandatory cooling-off period for company buyback plans would be especially problematic for accelerated share repurchase programs, or ASRs, because it would make their implementation more challenging and the cost of buying stock through ASRs more expensive. Companies would need to use a "forward starting" mechanic, which would complicate execution and undoubtedly increase the price paid to repurchase their stock.

    Particularly if the SEC moves ahead with its proposal to require daily reporting of company repurchase activity (discussed below), we think the SEC should be able to rely on the powers of sunlight to prevent companies from surreptitiously repurchasing stock when they are sitting on undisclosed good news, rather than install an arbitrary speed bump as a condition to taking advantage of the Rule 10b5-1 defense. If the SEC nevertheless adopts the cooling-off period as proposed, we believe some companies will simply choose not to avail themselves of the rule's potential protections.

– **Prohibition on overlapping plans**. Although some companies prohibit their insiders from maintaining more than one Rule 10b5-1 trading plan at once, this is not currently a condition to the rule's availability. Some commenters have speculated that insiders are thus able to run two simultaneous offsetting plans—one for stock sales, and the other for stock purchases—and simply terminate the plan that looks like it will be unprofitable based on inside information known to the trader. While there is not much evidence to suggest that this sort of nefarious activity is actually going on (and indeed Section 16 short-swing profits liability could make it perilous), the SEC intends to get rid of it, just in case.

  A transaction where insiders receive stock directly from the company, such as from an employee stock ownership or dividend reinvestment plan, would not be considered a prohibited overlapping plan. However, the common use of Rule 10b5-1 trading plans for share withholding upon vesting or delivery of equity awards would apparently be covered.

  A prohibition on overlapping plans would also preclude companies from executing two commonly used repurchase strategies—multi-dealer, alternating day ASRs, which companies use to further reduce the cost of buying their stock using an ASR and limit credit exposure to any one bank counterparty, and ASRs executed concurrently with an agency open-market repurchase plan. The regulatory benefit of preventing companies from using these cost and risk-minimization tools is not obvious, and we expect commenters to point this out as the SEC deliberates over these proposals.

– **Limitation on single-trade plans**. The Rule 10b5-1 defense would be available for only one "single trade" plan during any 12-month period. In view of the proposed cooling-off periods, it's hard to see what additional protection against illegal activity this disfavoring of single-trade plans is expected to achieve.

– **Mandatory reporting of *all* trading plans and insider-trading policies**. There is currently no requirement to publicly disclose the adoption, amendment or termination of a trading plan, and practice is mixed. In addition, companies are

Copyright 2021 Davis Polk & Wardwell LLP

not currently required to publicly disclose the details of their insider-trading policies, and most do not. The proposals would change both—and would apply whether or not trading plans are entered into pursuant to Rule 10b5-1 (which is usually the case, except for buyback plans only intended to satisfy Rule 10b-18).

- *Quarterly disclosure of trading plans*. A company would be required to disclose in its periodic reports any trading plans adopted or terminated by the company or any officer or director during the previous quarter, whether or not adopted under Rule 10b5-1. The disclosure would include:

  - the name and title of the officer or director, if applicable,
  - the date of adoption or termination,
  - the duration of the plan, and
  - the aggregate amount of securities to be sold or purchased under the plan.

- *Annual disclosure of insider-trading policies*. A company would be required to state in its annual report whether it has adopted policies and procedures for directors, officers and employees that are reasonably designed to promote compliance with insider trading laws (or explain why not). While not explicit in the proposed rule text, the proposal emphasizes that this disclosure should include "meaningful and detailed information," such as the process by which the company analyzes whether officers and directors (and the company itself) are in possession of MNPI, the process for documenting the analysis and approving requests to buy or sell securities, and how the company enforces compliance. The proposal also notes that these policies might cover dispositions other than purchases and sales, such as gifts of stock (more on which below).

  The SEC's focus on insider-trading policies as they relate to stock buybacks echoes its position in an October 2020 enforcement action, where it found a company's accounting controls inadequate to ensure compliance with its stated policy of executing buybacks in accordance with its insider-trading policy. This suggests companies may want to examine their practices around buybacks regardless of the outcome of these proposals.

- *Trade-by-trade disclosure*. If an insider trade was made under a Rule 10b5-1 trading plan, disclosure of the plan would be required in Form 4 or Form 5, as discussed below. Many companies already require their officers and directors to provide this disclosure.

– **Certifications**. Upon adopting a Rule 10b5-1 trading plan, an officer or director would be required to certify to the company in writing that they:

- are not aware of MNPI, and
- are adopting the plan in good faith and not as part of a plan to evade the prohibition against illegal insider trading.

  The certification would need to be kept by the officer or director for 10 years (creating paperwork headaches for individuals), but would not be required to be filed with the SEC.

– **"Operational" good faith requirement**. Currently Rule 10b5-1 trading plans must be *adopted* in good faith. The new rules would add a requirement that they also be *operated* in good faith. The SEC briefly explains this aspect of the proposal as needed to prevent insiders from improperly amending or cancelling plans, or improperly influencing the timing of corporate disclosures, but there are no express limitations in the text of the rule. If adopted as proposed, we predict this requirement would make Rule 10b5-1 trading plans substantially less practical to use and maintain. Today, a Rule 10b5-1 trading plan can be cancelled even when the trader is aware of MNPI, and well-advised companies and insiders sometimes take advantage of this flexibility in order to halt trading that might be perfectly legal but that might be viewed skeptically in hindsight, or that might be inconsistent with other activities that unexpectedly arise, like stock offerings by large shareholders. Determining whether any such activity runs afoul of the "operational" good faith requirement—or indeed, *even determining whether to allow a plan to run its course*—is likely to become a fraught exercise.

Proposed changes to option grant disclosure

Copyright 2021 Davis Polk & Wardwell LLP

The SEC's proposals relating to the disclosure of option grants come on the heels of its November 2021 accounting guidance on how companies should recognize and disclose the cost of equity compensation awards while in possession of MNPI, including "spring-loaded" grants. In that guidance, the SEC stated that, when estimating the fair value of a grant made while holding *favorable* MNPI, the company should consider adjustments to the exercise price and the expected volatility of the share price for Black-Scholes valuation purposes.

It's clear that spring-loading grant practices are in the SEC's crosshairs, even though this activity may not technically constitute illegal insider trading (and indeed was once praised by an SEC commissioner for offering companies a cost-effective means for remunerating employees). Thus far, the SEC has trained its fire on stock options and similar "appreciation" awards. Neither the proposal nor the recent accounting guidance addresses "full value" awards such as restricted stock units.

The proposal seeks to uncover company practices that time option grants around the release of MNPI, by requiring disclosure relating to:

- **Spring-loaded option grants**—option awards granted immediately before the release of favorable MNPI likely to result in an increase in the company's stock price, resulting in the options being in-the-money shortly following the grant date, and
- **Bullet-dodging option grants**—delaying the grant of option awards until after the release of unfavorable MNPI likely to result in a decrease in the company's stock price, thereby preventing the options from being underwater shortly following the grant date.

The proposal would require companies to provide annual proxy statement disclosure of each award of stock options, stock appreciation rights or similar awards that the company granted during the prior year to its named executive officers within 14 calendar days before or after:

- the filing of a periodic report (Form 10-K or 10-Q),
- the adoption of a stock buyback plan, or
- reporting MNPI on Form 8-K (including earnings).

The disclosure would be in tabular format and tagged in Inline XBRL (perhaps to make it easier for the SEC and plaintiffs' lawyers to spot potentially suspicious activity), and would include for each named executive officer, on an-award-by-award basis:

- the number of shares underlying the award,
- the date of grant,
- the grant date fair value of the award,
- the exercise price,
- the market price of the underlying shares on the trading day before disclosure of the MNPI (for potential spring-loaded options), and
- the market price of the underlying shares on the trading day after disclosure of the MNPI (for potential bullet-dodging options).

The proposal would also require a company to provide narrative disclosure in the Compensation Discussion and Analysis (CD&A) portion of the proxy statement about its option granting policies and practices regarding the timing of option grants and the release of MNPI, including how the board determines when to grant options and whether and how MNPI is taken into account. Although foreign private issuers would not be subject to this new disclosure requirement, smaller reporting companies and emerging growth companies are not exempt.

For the vast majority of companies whose compensation programs are administered in good faith, the disclosure ramifications of the SEC's proposals are likely to accomplish nothing more than making meetings of the compensation committee more difficult to schedule.

Proposed changes to Form 4 and 5 reporting, including gifts

Copyright 2021 Davis Polk & Wardwell LLP

The SEC's proposals to require reporting of Rule 10b5-1 trading were expected. But in a surprise, the SEC also put forth new requirements around charitable gifts of stock—or "insider gifting," as Chair Gensler referred to the practice. Around 40 minutes into the meeting announcing the proposals, the chair flatly stated that "charitable gifts of securities are subject to insider trading laws," perhaps in dialogue with a *Wall Street Journal* piece on the practice last summer.

It has long been understood that a charitable gift does not itself trigger application of the insider trading laws, since no "sale" takes place and the charity can't be defrauded, and the SEC seems to have had little interest in the practice until now. But given the chair's remarks, companies may want to think about the terms under which executives should be permitted to make stock gifts close to the end of December, a popular time for giving and for claiming tax deductions.

- **Reporting gifts on Form 4**. Section 16 insiders (officers, directors and 10% shareholders) are generally required to report changes in beneficial ownership of equity securities within two business days of the transaction, on Form 4. However, they may wait to report certain transactions, including bona fide gifts (both acquisitions and dispositions) until 45 days after the end of the company's fiscal year, through filing a Form 5.

  The proposed rules would instead require Section 16 insiders to report the donation (but not receipt) of company equity securities on Form 4 within two business days. The proposed rules would cover all recipients, including family members, trusts and other estate planning vehicles and 501(c)(3) charitable organizations. The SEC indicated that it is proposing the reporting change in order to provide investors with information to evaluate gift transactions in light of potential "problematic" practices, including gifts while the donor is in possession of MNPI, or backdating gifts in order to maximize the donor's tax benefit.

  In a footnote, the SEC stated: "For example, a donor of securities violates Exchange Act Section 10(b) if the donor gifts a security of an issuer in fraudulent breach of a duty of trust and confidence when the donor was aware of material nonpublic information about the security or issuer, and knew or was reckless in not knowing that the donee would sell the securities prior to the disclosure of such information." Because the SEC did not cite judicial precedent or other authority for this proposition, it is not entirely clear what the SEC believes would constitute a donation in fraudulent breach of a duty of trust and confidence.

  Despite the change in reporting requirements, a bona fide gift would remain exempt from short-swing profit disgorgement rules under Section 16 of the Securities Exchange Act of 1934.

- **Mandatory Rule 10b5-1 trading plan disclosure**. Currently, Section 16 insiders can voluntarily disclose whether a transaction reported on Form 4 or Form 5 was made pursuant to a Rule 10b5-1 trading plan. Insiders often disclose the existence of a Rule 10b5-1 trading plan this way in order to dampen any inference that the transaction (usually a sale) reflects the insider's private views of the company's near-term prospects.

  Under the SEC's proposal, all Section 16 insiders would be required to report whether a transaction reported on Form 4 or Form 5 was made pursuant to a Rule 10b5-1 trading plan. The amendments would:

  - add a mandatory checkbox indicating whether the transaction was made pursuant to a Rule 10b5-1 trading plan, and if so requiring disclosure of the date of plan adoption, and
  - add an optional checkbox that would allow an insider to indicate whether the transaction was made under an instruction or arrangement that is not designed to satisfy Rule 10b5-1.

Proposed new stock buyback disclosure

Under current rules, a company is required to disclose information about stock buybacks in its quarterly and annual reports, including:

- the number of shares purchased,
- the average price per share,
- the number of shares purchased as part of publicly announced plans, and
- the maximum amount that may be purchased under announced plans.

The SEC proposes to increase both the frequency and disclosure around stock buybacks.

Copyright 2021 Davis Polk & Wardwell LLP

- **New daily reporting requirement**. Companies, including foreign private issuers, would be required to report information about stock buybacks on a new “Form SR” within one business day, including:

  - the number of shares purchased,
  - the average price per share,
  - the number of shares purchased on the open market,
  - the number of shares purchased under the Rule 10b-18 safe harbor, and
  - the number of shares purchased under a Rule 10b5-1 trading plan.

  It is not clear how the proposed reporting requirement would apply to repurchases pursuant to an ASR, whether upon initial settlement of the ASR, by the bank counterparty over the term of the ASR or at final settlement of the ASR.

  In a bit of good news, Form SR would be “furnished” and not “filed,” and so a failure to meet the Form SR reporting deadline would not automatically result in loss of Form S-3 eligibility or “well-known seasoned issuer” status.

- **New periodic disclosure requirements**. In addition to daily reporting on Form SR, a company would be required to disclose in Forms 10-K, 10-Q and 20-F:

  - the objective or rationale for its repurchase plans, including the process through which the company determines the amount of repurchases,
  - the number of shares purchased and the nature of any transaction made outside of publicly announced plans pursuant to a Rule 10b5-1 trading plan and in reliance on the Rule 10b-18 safe harbor,
  - for publicly announced plans, the date each plan was announced, the dollar amount approved, the plan expiration date, each plan that has expired and each plan the company has terminated prior to expiration, and
  - any policies and procedures relating to the purchase or sale of the company’s stock by its officers and directors during pendency of a company buyback program.

  Companies would be required to disclose in their periodic reports (by checking a box) if any of their Section 16 insiders traded in company stock within 10 business days before or after the announcement of a share repurchase plan or program. This disclosure is designed to flag whether insiders may have opportunistically timed purchases or sales to take advantage of the price bump that may follow public announcement of a buyback plan.

Taken as a whole, daily reporting and more detailed disclosure surrounding stock buybacks (along with the new cooling-off period) raise a number of issues—particularly if daily reporting is required even for purchases that rely on the Rule 10b-18 safe harbor designed specifically to minimize the impact buybacks can have on trading prices. For example, a company’s pause of a buyback program could telegraph—correctly or not—the possible existence of MNPI and thus fuel otherwise-avoidable volatility in the stock. Daily reporting could also be valuable to professional traders who could use the information to trade against the company, to the detriment of its stockholders generally.

Given that company buybacks do not raise Williams Act corporate-control concerns where real-time reporting is needed, it seems possible that the additional information provided by daily disclosures would harm rather than help investors, and that the additional information will mostly be of interest to hedge funds and the plaintiffs’ bar. The new periodic disclosures could also, of course, attract SEC enforcement attention for actual or perceived discrepancies between a company’s activities and the way it describes its rationale and decision-making process.

Then again, perhaps the overriding purpose of all the new buyback rules is simply to disadvantage stock repurchases over other forms of returning value to stockholders—like dividends, which have not drawn the same degree of political opprobrium as buybacks. Buybacks have advantages over dividends—they can offset dilution inherent in equity compensation plans and offer more flexibility to companies than dividends, which are sometimes viewed as permanent features once announced. We expect commenters to make these points to the SEC.

Copyright 2021 Davis Polk & Wardwell LLP

If you have any questions regarding the matters covered in this publication, please reach out to any of the lawyers listed below or your usual Davis Polk contact.

Pedro J. Bermeo
+1 212 450 4091
pedro.bermeo@davispolk.com

Ning Chiu
+1 212 450 4908
ning.chiu@davispolk.com

Robert A. Cohen
+1 202 962 7047
robert.cohen@davispolk.com

Alan F. Denenberg
+1 650 752 2004
alan.denenberg@davispolk.com

Joseph A. Hall
+1 212 450 4565
joseph.hall@davispolk.com

Michael Kaplan
+1 212 450 4111
michael.kaplan@davispolk.com

James C. Lin
+852 2533 3368
james.lin@davispolk.com

Kyoko Takahashi Lin
+1 212 450 4706
kyoko.lin@davispolk.com

Mark M. Mendez
+1 212 450 4829
mark.mendez@davispolk.com

Shane Tintle
+1 212 450 4526
shane.tintle@davispolk.com

Travis Triano
+1 212 450 3096
travis.triano@davispolk.com

Richard D. Truesdell, Jr.
+1 212 450 4674
richard.truesdell@davispolk.com

This communication, which we believe may be of interest to our clients and friends of the firm, is for general information only. It is not a full analysis of the matters presented and should not be relied upon as legal advice. This may be considered attorney advertising in some jurisdictions. Please refer to the firm's privacy notice for further details.

Copyright 2021 Davis Polk & Wardwell LLP