Davis Polk

SEC's Investor Advisory Committee recommends changes to Rule 10b5-1 trading plans

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Changes are on the horizon for a risk management tool widely used by both insiders and companies

Responding to a recent call from SEC Chair Gary Gensler to "freshen up" Rule 10b5-1, a subcommittee of the SEC's Investor Advisory Committee (IAC) released draft recommendations on August 26 calling for changes to the operation of Rule 10b5-1 securities trading plans. The recommendations, which don't seem to distinguish between insider selling plans and company repurchase plans, include a four-month "cooling off" period between plan adoption and the first trade, as well as mandatory disclosure of Rule 10b5-1 plans. The IAC also recommends expanding Form 4 reporting requirements to include insiders of foreign private issuers. Although the IAC has no formal role in SEC rulemaking, the recommendations are likely to inform the agency's thinking as it develops proposals for amending Rule 10b5-1.

[*Note: Since the initial publication of this memo, the Investor Advisory Committee approved the draft recommendations at its September 9th meeting, with the understanding that the recommendations would be revised to make clear that they do not apply to company repurchase plans.*]

Rule 10b5-1

Directors, officers and other company insiders, and of course companies themselves, are often in possession of material nonpublic information (MNPI) about the company, yet from time to time want to be able to buy or sell company securities. A company insider's need to sell company securities may be especially acute when a significant portion of the insider's compensation takes the form of equity awards. Recognizing the legitimate interest in being able to trade in company securities without running afoul of insider trading laws—buying or selling securities on the basis of MNPI—in 2000 the SEC adopted Rule 10b5-1 to provide an "affirmative defense" to potential charges of insider trading when trades are made pursuant to a contract, instruction or plan that satisfies the rule's requirements. Rule 10b5-1 plans today are frequently used by company insiders to sell securities, and by companies to repurchase securities, in a manner that minimizes the risk of trading on the basis of MNPI. (Rule 10b5-1 plans are less frequently used by insiders to buy securities, and generally cannot be used by companies to sell securities.)

The affirmative defense against insider trading is available to an insider or company who establishes a Rule 10b5-1 trading plan before becoming aware of MNPI. There is currently no cooling-off requirement (although a cooling-off period is often a feature of insider selling plans), and while plans may only be amended when the insider or company is not in possession of MNPI, plans may be cancelled even while in possession of MNPI. This ability to cancel a plan and thereby halt trading can provide needed flexibility when other legal restrictions on trading arise or when circumstances unexpectedly change.

Calls to reform Rule 10b5-1 have been mounting for several years. More recently, in 2020, former SEC Chair Jay Clayton

recommended mandatory cooling-off periods after the adoption, amendment or termination of a plan. Bipartisan legislation re-introduced in the U.S. Senate in June 2021 would direct the SEC to study whether Rule 10b5-1 should be amended to:

- limit the timeframe during which a company or insider can adopt a trading plan to company-approved trading windows
- limit the ability of companies and insiders to adopt multiple trading plans
- establish a mandatory cooling-off period between the adoption of the trading plan and the first trade under the plan
- limit the frequency that companies and insiders can modify or cancel trading plans
- require companies and insiders to publicly file trading plans, amendments, terminations, and transactions with the SEC; and
- require boards to adopt policies for trading plans and monitor trading plan transactions.

The SEC placed Rule 10b5-1 on its Spring 2021 rulemaking agenda, after which Chair Gensler stated in a speech that Rule 10b5-1 plans "have led to real cracks in our insider trading regime." The chair identified four areas of concern:

- no cooling-off period before the first trade
- no limit on when Rule 10b5-1 plans can be cancelled
- no public disclosure regarding Rule 10b5□1 plans; and
- no limit on the number of Rule 10b5-1 plans that can be adopted.

IAC recommendations

The IAC recommendations include:

- **A cooling-off period** of at least four months between the adoption of a Rule 10b5-1 plan and the first trade under the plan, intended to ensure that adoption and trades cannot happen in the same quarter. The recommended cooling-off period would apparently apply to Rule 10b5-1 plans governing both insider sales and company repurchases.
- **A prohibition on overlapping plans**, or having more than one Rule 10b5-1 trading plan in place at the same time.
- **Mandatory disclosure regarding Rule 10b5-1 plans, including:**
  - Proxy statement disclosure of the number of shares covered under Rule 10b5-1 trading plans for both the company and its named executive officers. (The recommendations focus on company plans established for the purpose of selling treasury shares, which in our experience would be problematic and quite unusual.)
  - Required Form 8-K disclosure of the adoption, modification or cancellation of Rule 10b5-1 plans.
  - Modification of Form 4 to indicate whether the reported trade was pursuant to a Rule 10b5-1 plan and, if so, the date of plan adoption or modification.
  - Expansion of Form 4 reporting to include insiders of all companies with securities listed on U.S. exchanges, including foreign private issuers. (The recommendations are silent as to whether insiders of foreign private issuers should become subject to Section 16 liability as well as Form 4 reporting, and do not specify whether Form 4 reporting should apply only to Rule 10b5-1 trades.)
  - Required electronic submission of Form 144 (currently, most filers submit Form 144 on paper, which has led to criticism around lack of transparency.)

Next steps

The SEC seems poised to propose changes to Rule 10b5-1 that would impact both insiders and companies. With any luck, the SEC will recognize that different policy considerations are at play for insider selling plans and company repurchase plans, and not impose blanket requirements applicable to both.

Cooling-off periods, for example, are routinely imposed on insider selling plans, but rarely on company repurchase plans. When implemented thoughtfully, a cooling-off period for an insider selling plan can reduce the perception and possibility that a plan was entered into in order to avoid losses that will materialize at the company's next earnings announcement. On the other hand, we have not heard much concern that companies enter into repurchase plans in order to take advantage of the market's lack of awareness of yet-to-be disclosed good news.

With respect to insider selling plans, we question whether a rigid four-month cooling-off period is necessary. As long as trading does not begin until after the company's next earnings announcement, insiders cannot benefit from advance knowledge of negative near-term business trends. Many companies' "window" policies close the trading window on the first or 15th of the last month of the quarter and re-open the window when the company reports earnings, around four weeks after quarter-end. Tying any mandatory cooling-off period to the company's own public reporting cadence would seem more sensible than a one-size-fits-all approach.

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.

Maurice Blanco
+55 11 4871 8402
+1 212 450 4086
maurice.blanco@davispolk.com

Ning Chiu
+1 212 450 4908
ning.chiu@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

Emily Roberts
+1 650 752 2085
emily.roberts@davispolk.com

Byron B. Rooney
+1 212 450 4658
byron.rooney@davispolk.com

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