House Passes 8-K Trading Gap Act

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Last week, the House overwhelmingly passed legislation aimed at closing what lawmakers have called a "loophole" for insider trading—corporate insiders trading between the occurrence of a corporate event and its disclosure through a Form 8-K filing (the "8-K Gap"). The 8-K Trading Gap Act ("the Bill") passed with broad bipartisan support. If passed by the Senate and enacted into law, it would require public companies to adopt policies and procedures reasonably designed to prevent corporate insiders from trading before Form 8-K disclosures. Although most or all public companies already have internal policies to prevent insider trading, the Bill would require policies as a matter of law, would create a new risk of SEC enforcement action if a company's policies are deemed unreasonable, and would require that policies extend to some announcements even if they do not involve material information.

The House Wants Public Companies to Mind the 8-K Gap

The Bill would amend the Securities Exchange Act of 1934 to require the SEC to adopt rules that would mandate that public companies bar executive officers and directors from trading between the time a reportable event occurs and the Form 8-K filing about the event. The SEC would be required to adopt rules requiring public companies to "establish and maintain policies, controls, and procedures reasonably designed" to prohibit executive officers and directors from trading in or transferring any equity security of the company (either directly or indirectly) during the 8-K Gap. For filings required by **Sections 1 through 6** of Form 8-K, trading would be prohibited from the time of the event triggering the filing requirement and the filing of the Form 8-K. For discretionary filings under Sections 7 and 8, trading would be prohibited from the "date on which the issuer determines it will" file a Form 8-K disclosing the event to the date on which the company files a Form 8-K.

The Bill includes exemptions around the events described in Sections 1 through 6 of Form 8-K that are announced in a Reg FD-compliant method, as well as transactions of registered investment companies and advisors to such companies that are subject to code of ethics requirements. The Bill would permit, but not require, the SEC to exempt transactions that it "determines [are] appropriate," including transactions that occur automatically, are made pursuant to an advance election, or are made pursuant to 10b5-1 plans (except for plans adopted during an 8-K Gap).

The origins of the Bill trace back to a 2015 **quantitative study** of trading by public-company insiders during 8-K Gaps conducted by law professors at Harvard and Columbia. The study's authors, including Robert J. Jackson, Jr., who later became an SEC commissioner, found "systematic abnormal returns" and urged Congress and the SEC to consider whether this reporting window creates opportunities for insider trading. On January 13, 2020, the Bill passed by a strong bipartisan margin of 384-7 and was referred to the Senate Committee on Banking, Housing, and Urban Affairs for consideration. A companion bill was introduced in the Senate last fall. The Senate Banking Committee has not yet announced when it will consider the legislation.

The Bill comes at a time of increased bipartisan congressional focus on insider trading. On December 5, 2019, the House passed the **Insider Trading Prohibition Act**, an attempt to codify aspects of insider trading case law, by a margin of 410-13. This bill also awaits consideration in the Senate.

If Passed by the Senate and Enacted into Law, the Bill Would Create Significant New Compliance Requirements and Potentially Increase Enforcement Activity

Most public companies already have policies and procedures to prevent insider trading, such as blackout periods that prohibit trading when insiders have material nonpublic information. Accordingly, it is not clear that the Bill would significantly decrease the likelihood of insider trading. However, if enacted, the Bill would have a substantial impact on public companies by creating new compliance obligations and risk of enforcement action:

- The Bill would impose trading-related compliance requirements for public companies as a matter of federal securities law. Although most companies already have policies in place, they generally are not required by federal law. This new legal requirement would create the risk of SEC enforcement action against a company if the SEC concludes that a company's policies are not reasonably designed. It also would increase the risk of an investigation into a company's policies, including the company's enforcement of these policies, as opposed to investigations focused solely on individuals who traded or tipped others. This type of corporate liability currently applies to regulated entities, such as broker-dealers and investment advisers, but would be new for most public companies.
- While current policies are generally focused on *material* information, the Bill would require that policies and procedures also address *nonmaterial* information if the company is required to file a Form 8-K or elects to file a discretionary Form 8-K. These policies also would need to address circumstances that may arise unexpectedly, unlike regular blackout periods that align with quarterly earnings releases.
- As drafted, the Bill raises questions as to the identification of "the date on which the issuer determines it will disclose such event" for discretionary Form 8-K filings, which is the date from which trading would be prohibited. Absent clarification, the rules could discourage public companies from keeping the market informed through discretionary disclosures and filings.
- By prohibiting trading without reference to intent, the rules would make SEC enforcement investigations much more likely when trading occurs within 8-K Gaps, even if that trading were inadvertent.
- In August 2019, the SEC brought its first **Reg FD action** in over five years, an indicator of potential renewed enforcement interest in Reg FD and a focus on disclosure-related actions against public companies more broadly.

The Bill will impact public companies only if the Senate passes it and President Trump signs the legislation into law. However, the Bill's broad bipartisan support suggests that some of the legal obligation of preventing insider trading, currently borne primarily by regulated entities such as broker-dealers, investment advisers, and stock exchanges, could soon be shared by public companies—who typically are the victims of insider trading when it occurs.

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

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