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Repairing A "Crack" in Insider Trading Regulation: SEC Rule 10b5-1 Trading Plans Face Increased Scrutiny

INTRODUCTION

SEC Rule 10b5-1 plans have long provided an effective means for corporate insiders to buy and sell their own company's securities without fear of civil or criminal insider trading liability, but these plans have come under increasing criticism from lawmakers, regulators, academics, and other commentators who contend that loopholes in the rule allow insiders to game the system. Critics got a significant boost when outgoing SEC Chair Jay Clayton late last year acknowledged some of the alleged shortcomings in the rule.[1] More recently, current SEC Chair Gary Gensler expressed his own concerns about potential loopholes – "cracks" as he labeled them – and announced he had asked SEC staff to consider potential amendments to Rule 10b5-1.[2]

This alert briefly reviews the basics of Rule 10b5-1 plans, discusses the principal concerns raised by their detractors, and suggests the potential reforms most likely to be seriously considered by the SEC and its staff.

RULE 10b5-1 BASICS

As interpreted by courts, Section 10(b) of the Securities Exchange Act of 1934 (the "Exchange Act") and SEC Rule 10b-5 thereunder prohibit corporate insiders from buying or selling securities "on the basis of material nonpublic information."[3] The dilemma for many corporate insiders is that the nature of their jobs ensures that they are frequently in possession of material nonpublic information or other nonpublic information that in hindsight could be deemed material nonpublic information. Thus, they face significant risk of being accused of insider trading whenever they buy or sell company securities, even after the issuance of earnings releases. This predicament is especially problematic for the many executives whose company securities comprise a substantial portion of their personal assets, because it

severely restricts their ability to liquidate those securities for a variety of reasons, including an understandable desire to diversify those assets.

Recognizing this reality, the SEC in August 2000 promulgated Rule 10b5-1, which among other things provides an affirmative defense where an insider's trading is made pursuant to a pre-established written plan that satisfies the requirements of the rule. To qualify for the affirmative defense, the insider's plan must be established before the insider became aware of material nonpublic information and must either: (1) specify the amount of securities to be traded, the price at which the securities are to be traded, and the date on which the securities are to be traded; (2) include a written formula or algorithm for determining the amount, price and date; or (3) prohibit the insider from exercising any substantial influence over how, when, or whether to effect trades.

Rule 10b5-1 plans have been widely used by company insiders in the two decades since the SEC adopted the rule. Plans come in all shapes and sizes, and there is no "average" or "typical" plan. Some are as simple as a written instruction to sell 10,000 shares at the prevailing market price on a specified future date, while others adopt more comprehensive plans with complicated formulas and contingencies that determine whether, when, and how much to buy or sell over an extended period of time. In addition, some executives adopt "short term" plans that are structured in connection with specific corporate events and then terminate their plans and enter new ones at a later time. One example of this practice is the adoption of, and immediate trading under, plans created shortly before earnings announcements. This practice of adopting and then terminating plans after short term trading objectives have been realized has drawn criticism from senior SEC staff, but is currently allowed by the rule provided its other requirements are met.

CALLS FOR REFORM

While the SEC has viewed insider trading controls as "an important part of good corporate hygiene,"[4] and while Rule 10b5-1 plans have long attracted skepticism from regulators, academics, and others,[5] concerns about the inadequacies of Rule 10b5-1, and the controls around plans adopted under the rule, have gained considerable steam over the past year or so. In the spring of 2020, as the COVID-19 pandemic was in perhaps its most disruptive initial phases, several SEC leaders – including then-Chair Jay Clayton – stressed the important role corporate insiders play in maintaining market integrity.[6] Specifically, these leaders warned that insiders were regularly learning new material nonpublic information that could hold greater value during such tumultuous periods than under normal circumstances.[7] According to current Chair Gary Gensler, one way to promote market integrity during such times is by identifying and punishing abuses of Rule 10b5-1 plans.[8]

In a September 2020 letter to the Chairman of the House Financial Services Subcommittee on Capital Markets and Investor Protection, then-Chair Clayton expressed his view that "companies should strongly consider requiring all Rule 10b5-1 plans for senior executives and board members to include mandatory seasoning, or waiting periods, after adoption, amendment or termination before trading under the plan may begin or recommence." He reasoned that waiting periods would "demonstrate that a plan was executed in good faith, but they also can bolster investor confidence in management teams and in markets generally."[9] A month later, the SEC issued a settled administrative order charging Andeavor LLC with failing to devise and maintain adequate internal controls surrounding its buyback of company stock pursuant to a corporate Rule 10b5-1 plan – a plan that had no waiting period, was entered into on the eve of a significant buyback, and triggered immediate trading.[10]

Following these developments, in December 2020, a Columbia Law School professor released his working draft of a research paper suggesting, among other things, that public companies disproportionately disclose positive news on days when their executives are selling company shares pursuant to Rule 10b5-1 plans.[11] Shortly thereafter in

January 2021, another academic study released by the Rock Center for Corporate Governance at Stanford University cited extensive research – admittedly inconclusive – that suggested possible abuse of Rule 10b5-1 plans, especially those with short waiting periods between adoption and trading, those involving only a single trade, and those adopted shortly before a company's quarterly earnings announcements.[12]

After the release of these academic studies, three U.S. Senators sent a letter in February 2021 to then-Acting SEC Chair Allison Herren Lee in which they criticized Rule 10b5-1 plans for their "lack of transparency, damage [to] investors and risk [of] undermining public confidence."[13] The Senators suggested that "[t]hese plans were designed to prevent insider trading, but new evidence indicates that executives … are abusing these plans to obtain huge windfalls at the expense of ordinary investors." The senators proposed a number of reforms that the SEC might implement to address these alleged abuses, including a four-to-six month "cooling off" period between the adoption of a plan and the beginning of trading, mandatory disclosure of trades made pursuant to a plan (including details concerning the terms of the plan), and stricter enforcement of existing filing deadlines to ensure transparency around trades soon after they are conducted.

Most recently, in remarks made earlier this month at *The Wall Street Journal*'s CFO Network Summit, current SEC Chair Gary Gensler joined the calls for reform. In his remarks, Chair Gensler faulted Rule 10b5-1 plans for causing "real cracks in our insider trading regime" and said he has asked SEC staff to make recommendations for how the agency might "freshen up" the rule.[14] His suggested reforms included some of those proposed by the academics and legislators mentioned above – such as mandatory cooling off periods and increased public disclosure of plans – but he went further in suggesting limitations on when and under what circumstances a plan can be canceled and limitations on the number of plans an insider may adopt and maintain at any given time. Not surprisingly, Rule 10b5-1 reform soon thereafter appeared as a line item on the SEC's annual regulatory agenda issued on June 11, 2021.[15]

POTENTIAL AMENDMENTS

We summarize below the Rule 10b5-1 reforms most likely to be considered by the SEC, including those mentioned above as well as several others.

Cooling-Off Periods

A growing consensus seems to be emerging that the SEC should consider imposing a mandatory "cooling off" period (or, in the words of former SEC Chair Clayton, a "seasoning" period), probably measured in months, between the adoption or modification of a plan and the commencement of trading pursuant to the plan. The above-noted Stanford research study found that executives at over 100 companies used Rule 10b5-1 plans that executed trades the same day that they adopted such plans,[16] and SEC Chair Gensler cited the same research in noting that 14% of sales occur within 30 days of a plan's adoption.[17]

Proponents of cooling off periods say the mandatory delay would substantially reduce the temptation for executives to abuse plans for short-term trading and would increase investor confidence in the good faith of corporate executives who use plans.[18] On the other hand, a lengthy mandatory cooling off period could significantly limit the utility of Rule 10b5-1 plans, particularly when circumstances arise – such as unexpected personal or medical expenses – in which executives need to liquidate shares relatively quickly for wholly legitimate reasons. The SEC will need to carefully balance the benefits of cooling off periods against the possible hardships they might impose.

Increased Public Disclosure of Plans

Another frequently mentioned Rule 10b5-1 reform proposal involves increased public disclosure of trading plans. As noted above, current disclosure requirements for Rule 10b5-1 plans are minimal and company practices have been inconsistent. SEC Chair Gensler and others have suggested that increased transparency about plans would enhance confidence in our markets, and we believe it likely that any reform proposals from the SEC will indeed include enhanced disclosure requirements. The more difficult question for the SEC will be the level of detail required to be disclosed. While disclosure of basic plan details – such as the date of adoption, the date range of anticipated trading, and the anticipated number of shares to be traded – might garner broad support, excessive disclosure of granular plan details or of the plan's specific mechanics, algorithms, and trading strategies could raise personal privacy concerns with little obvious benefit to ordinary investors. Furthermore, disclosure of plan details may invite trading designed to disrupt or front-run an executive's planned trading. A requirement that Form 4 filings explicitly indicate whether a trade was made pursuant to a Rule 10b5-1 plan also seems likely, as does a requirement, as discussed further below, that Rule 144 filings (which already require the filer to at least disclose the date of adoption of any plan pursuant to which a sale is made) be filed electronically and made available to the public through the EDGAR system.

Limits on Plan Cancellations

As SEC Chair Gensler recently noted, current rules place no restriction on when a Rule 10b5-1 plan can be canceled, which he called "upside-down." He is concerned that executives may be adopting plans while not in possession of material public information and later canceling them with hindsight after they learn material nonpublic information that renders the plan ill-advised, which could be as economically advantageous as adopting a plan while in possession of such information. These kinds of plan cancellations tend to be largely invisible because of the impossibility of identifying a transaction that never takes place. Because the Chair has explicitly raised this concern, the SEC staff is almost certain to give it very serious consideration and recommend at least some limitations on the ability to cancel an existing plan. Although it seems unlikely the SEC would prohibit the cancellation of plans entirely, proposals might include mandatory waiting periods between the adoption and cancellation of plans (and vice versa), or limits on the number of times an executive can adopt and cancel plans within a given period of time.

Limits on Establishing Multiple Contemporaneous Plans

SEC Chair Gensler also specifically called out the contemporaneous use of multiple plans by executives, so the SEC staff will almost certainly be looking into this concern as well. Chair Gensler's basic concern is that, under current rules, an executive might legally adopt multiple plans with diverse instructions, essentially to keep all options open as time goes by. Based on the future market price and trajectory of the company's stock, the executive might then cancel one or more plans that in hindsight appear to be ill-fated while keeping in place the more advantageous ones. Given the Chair's comments, it seems likely that any SEC proposals to amend Rule 10b5-1 will place at least some restrictions on the number of contemporaneous plans an executive may have in effect at any given time.

Stricter Enforcement of Section 16 Filing Deadlines

Similarly, some have urged the SEC to intensify its enforcement of filing deadlines for Exchange Act Section 16 filings on SEC Forms 3, 4, and 5.[19] Under current rules, company directors and executive officers must disclose trades in their own company's securities to the SEC on these forms within two business days. According to one study, however, executives have filed forms for more than 14,000 trades since 2014 that were more than ten days late. Although the SEC has historically committed resources to enforcing these deadlines, we expect the agency to increase those resources and perhaps to specifically request new funds to do so in future budget requests, especially

if the SEC amends its rules to require disclosure of Rule 10b5-1 plans in Section 16 filings that report transactions made under plans.

Elimination of Mail-In Form 144 Filings

Rule 10b5-1 critics have also urged the SEC to stop permitting company executives to submit Form 144 filings by mail. These forms are used by executives and other company affiliates when they plan to sell restricted or control shares pursuant to SEC Rule 144, which provides an exemption from registration where certain conditions are met. When an executive's Rule 144 transaction is made pursuant to a Rule 10b5-1 plan, Form 144 requires the filer to disclose the date (and by implication the existence) of the plan – although not the details of the plan.

Form 144 filers are currently permitted to submit their forms electronically through EDGAR, but they are also allowed to file them in paper form by first class mail instead. The SEC stores the mailed-in forms in paper form for a limited time period while making them available for viewing in a reading room at the SEC, but the agency does not make them readily available on EDGAR. Noting that the "vast majority" of Form 144 filings are currently filed in paper form, the SEC in December 2020 proposed a range of amendments to Rule 144, one of which would require these forms to be filed electronically through EDGAR. Given the absence of public disagreement expressed by any commissioner at the time (or since), we suspect this amendment has broad support and will ultimately become law.

Modification of the Short-Swing Profits Rule

At least one academic has also proposed that the SEC work with Congress to modify Exchange Act Section 16(b), which effectively requires corporate officers (and certain others) to disgorge any profits they realize when they purchase and then sell company securities (or sell and then purchase company securities) within a six-month period.[20] Based on his research suggesting that Rule 10b5-1 selling disproportionately occurs on days when companies disclose positive news, and that these sales tend to coincide with "ephemeral" stock price increases beneficial to the sellers that are then followed disproportionately by stock price declines over the next 10 days, this academic suggests that Section 16(b) should be amended to require disgorgement in these scenarios regardless of whether the executive purchased the relevant shares less than six months earlier (or repurchases shares less than six months later).[21] He contends that expansion of the disgorgement mandate to these circumstances would disincentivize executives from pursuing short-term gains at the expense of investors while rewarding those who create long-term value for the company and its shareholders. To our knowledge, this proposal has not gained traction among regulators or lawmakers.

KEY TAKEAWAYS

Even before SEC Chair Gensler's recent remarks expressing concerns about Rule 10b5-1 plans, critics of these plans had been picking up considerable steam over the past year in their calls for reform. In January 2019, the House of Representatives passed the Promoting Transparent Standards of Corporate Insiders Act (H.R. 624) by a vote of 413-3, which would have directed the SEC to undertake a study analyzing whether Rule 10b5-1 should be amended, thereby suggesting significant, recent, and bipartisan support for these proposals.[22] That bill, which stalled in the Senate, would have specifically required the SEC to consider rule amendments such as allowing insiders to adopt Rule 10b5-1 plans only during specified trading windows, imposing mandatory trading delays after adoption of a plan, and requiring disclosure of plan adoptions and modifications.[23] On April 20, 2021, the House passed an identical bill (H.R. 1528) by a vote of 355-69.[24]

Further, although there have been very few SEC enforcement actions alleging abuse of Rule 10b5-1 plans in over twenty years, the SEC's settlement with Andeavor LLC and Chair Gensler's focus on this "crack" in insider trading

regulation perhaps presage a more aggressive enforcement policy ahead.[25] In any event, with the SEC Chair now firmly on board with revisiting Rule 10b5-1, changes to the rule appear highly likely, especially those aimed at increased transparency and the elimination of perceived opportunities to game the system. Corporate executives and company counsel are well advised to stay alert to these potential rule changes and perhaps even to adjust their plans, policies, and procedures anticipatorily.

[1] Paul Kiernan, *SEC Chairman Urges Corporate Insiders to Avoid Quick Stock Sales*, WALL ST. J. (Nov. 17, 2020), https://www.wsj.com/articles/sec-chairman-urges-corporate-insiders-to-avoid-quick-stock-sales-11605637892.
[2] Gary Gensler, Chair, Secs. & Exch. Comm'n, Prepared Remarks CFO Network Summit (June 7, 2021), https://www.sec.gov/news/speech/gensler-cfo-network-2021-06-07.
[3] *See generally Salman v. United States*, 137 S. Ct. 420 (2016); *United States v. O'Hagan*, 521 U.S. 642 (1997).
[4] Robert J. Jackson Jr., Comm'r, SEC, Corporate Governance: On the Front Lines of America's Cyber War, (Mar. 15, 2018) (quoting Testimony of SEC Chairman Jay Clayton before Senate Committee on Banking, Housing, and Urban Affairs), https://www.sec.gov/news/speech/speech-jackson-cybersecurity-2018-03-15.
[5] *See, e.g.*, Linda Chatman Thomsen, Opening Remarks Before the 15th Annual NASPP Conference (Oct. 10, 2007), https://www.sec.gov/news/speech/2007/spch101007lct.htm (citing academic studies from the mid-2000s).
[6] Stephanie Avakian and Steven Peikin, Co-Dirs. Div. Enf't, SEC, Statement from Stephanie Avakian and Steven Peikin, Co-Directors of the SEC's Division of Enforcement, Regarding Market Integrity (Mar. 23, 2020), https://www.sec.gov/news/public-statement/statement-enforcement-co-directors-market-integrity; Jay Clayton, Chairman, and William Hinman, Dir. Div. Corp. Fin, SEC, The Importance of Disclosure – For Investors, Markets and Our Fight Against COVID-19 (Apr. 8, 2020), https://www.sec.gov/news/public-statement/statement-clayton-hinman.
[7] Id.
[8] Hon. Gary Gensler Prepared Remarks, supra note 2.
[9] Letter from Jay Clayton, Chairman, Secs. & Exch. Comm'n, to Brad Sherman, U.S. House of Reps. (Sept. 14, 2020), https://www.sec.gov/files/clayton-letter-to-chairman-sherman-20200914.pdf.
[10] *See* Richard H. Walker, Russ Ryan & Jacob Gerber, *SEC's Expansive View of "Accounting Controls" Draws Unusual Dissent from Two Commissioners*, KING & SPALDING (Dec. 16, 2020), https://www.kslaw.com/news-and-insights/secs-expansive-view-of-accounting-controls-draws-unusual-dissent-from-two-commissioners.
[11] *See* Joshua Mitts, *Insider Trading and Strategic Disclosure* 3 (Columbia L. Sch. & Econ. Working Paper, Dec. 7, 2020).
[12] David F. Larcker et al., *Gaming the System: Three "Red Flags" of Potential 10b5-1 Abuse*, STANFORD CLOSER LOOK SERIES, (Jan. 18, 2021), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3769567&download=yes [hereinafter the "Stanford Study"].
[13] Letter from Sen. Elizabeth Warren, Sen. Sherrod Brown & Sen. Chris Van Hollen, U.S. Senate, to Allison H. Lee, Acting Chair, Secs. & Exch. Comm'n (Feb. 10, 2021) [hereinafter Senate Letter], https://www.warren.senate.gov/imo/media/doc/02.10.2021%20Letter%20from%20Senators%20Warren,%20Brown,%20and%20Van%20Hollen%20to%20Acting%20Chair%20Lee.pdf.
[14] Hon. Gary Gensler Prepared Remarks, supra note 2.
[15] Press Release, Secs. & Exch. Comm'n, SEC Announces Annual Regulatory Agenda (June 11, 2021), https://www.sec.gov/news/press-release/2021-99.
[16] Stanford Study, *supra* note 12, at 2; *see also* Alan Jagolinzer et al., *How the SEC Can and Should Fix Insider Trading Rules*, THE HILL (Dec. 17, 2020), https://thehill.com/opinion/finance/530668-how-the-sec-can-and-should-fix-insider-trading-rules.
[17] Hon. Gary Gensler Prepared Remarks, supra note 2.
[18] A similar limitation on plans of short duration, or "one trade plans", would accomplish the same objective.
[19] Alan Jagolinzer et al., *supra* note 16.
[20] 15 U.S.C. § 78p(b).
[21] *See* Joshua Mitts, *supra* note 11.
[22] Promoting Transparent Standards of Corporate Insiders Act, H.R. 624, 116th Cong. (2019-2020).
[23] NICOLE VANATKO, CONG. RESEARCH SERV., LSB10249, REEXAMINING THE RULE 10B5-1 TRADING PLAN DEFENSE TO INSIDER TRADING 3 (2019).
[24] Promoting Transparent Standards of Corporate Insiders Act, H.R. 1528, 117th Cong. (2021-2022).
[25] Press Release, Secs. & Exch. Comm'n, SEC Charges Andeavor for Inadequate Controls Around Authorization of Stock Buyback Plan (Oct. 15, 2020), https://www.sec.gov/news/press-release/2020-258.