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SEC adopts major changes for insider transactions

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In a significant and welcome change from the SEC's proposal, the agency will not mandate cooling-off periods for 10b5-1 plans used for corporate stock buybacks. For plan use by directors, officers and other insiders, the rules add cooling-off periods and mandate new disclosures. The rules also include new disclosure requirements for option grants and stock gifts.

On December 14, 2022, the Securities and Exchange Commission adopted new rules focused on Rule 10b5-1 trading arrangements and other securities transactions involving corporate insiders, including directors and officers. In many respects the new rules track the agency's proposals from a year ago, although the SEC responded to certain concerns raised by commenters, yielding what we consider to be an improved set of changes to its rulebook over the original version. In particular, the SEC did not adopt changes that would have unnecessarily interfered with corporate stock repurchase programs, such as a proposed 30-day cooling-off period for issuer use of the Rule 10b5-1 safe harbor.

Chair Gensler deserves credit for shepherding the proposals through a constructive rulemaking process and achieving unanimous support from his fellow commissioners on a complex subject that easily could have splintered along partisan lines. Heading into the new year, we are optimistic that the SEC may take a similarly pragmatic approach to some of the other consequential items pending on its rulemaking agenda, including additional rules governing stock buybacks and climate risk disclosures.

Compliance dates

The final rules are effective on February 27, 2023. Except where noted below, the rules apply to all SEC registrants, including foreign private issuers.

- **New rules on 10b5-1 plans.** The amendments to Rule 10b5-1 do not affect plans adopted prior to the effective date. A plan that is modified after the effective date would be treated as if it were adopted after the effective date and therefore would be subject to the amended rule. Accordingly, companies and shareholders can continue to adopt plans under the existing rules until the effective date.
- **Disclosure and tagging requirements.** Companies (other than smaller reporting companies) will be required to comply with new disclosure and XBRL tagging requirements in their reports on Forms 10-Q, 10-K and 20-F as well as proxy or information statements in the first filing that covers the first full fiscal period that begins on or after April 1, 2023, or the second quarter 10-Q for calendar-year companies. Smaller reporting companies on the calendar year will be required to comply by the 2023 10-K.
- **Forms 4 and 5.** Section 16 insiders will be required to comply with the new form requirements for beneficial ownership reports filed on or after April 1, 2023. However, the amendments to Rule 16a-3 will become effective on February 27, 2023. This means that gifts made on or after that date will need to be reported on a Form 4 within two business days.

What to do now. Companies should consider revising their Rule 10b5-1 guidelines and insider trading policies to account for the new mandated cooling-off periods, restrictions and certification requirements discussed below.

Rule 10b5-1 trading plans

Rule 10b5-1 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 adopting the following major changes to make sure it doesn't happen.

Mandatory cooling-off periods for insiders (but not for companies)

Rule 10b5-1 as currently in effect does not impose any waiting period between the time a plan is adopted or amended and the date of the first trade under the plan. The amended rule changes that as follows:

- **At least 90 days for directors and officers.** The amendments include a mandatory cooling-off period following adoption or modification of a plan, the length of which is somewhat more flexible than the 120 days originally proposed. Under the final rule, the cooling-off period begins on the date of plan adoption or modification and ends the *later* of (1) 90 days thereafter and (2) two business days following filing of a Form 10-Q or 10-K (or 6-K or 20-F) covering the financial reporting period in which the plan was adopted or modified, but in no event later than 120 days. The SEC concluded that an earnings release alone is not sufficient to satisfy the second prong, and so for 10b5-1 plans entered after third quarter earnings, the cooling-off period may be closer to 120 days.
- **30 days for traders other than directors and officers.** In a departure from the proposal, the final rule also adds a cooling-off period of 30 days for traders other than directors and officers.
- **No cooling-off period for companies.** The SEC did not adopt a proposed 30-day cooling-off period for plans adopted by companies. This is a welcome change from the proposal given that a cooling-off period for companies would have substantially interfered with ordinary corporate buyback programs and would have been especially problematic for accelerated share repurchases (ASRs), as we noted in our comment letter to the SEC.

In another helpful change from the original proposal, only certain types of plan modifications will trigger a new cooling-off period. Modifications that do not change the pricing, amount of securities or timing of trades will not trigger a new cooling-off period. The final rule would also not treat as a modification instances where a broker executing trades on behalf of the insider under Rule 10b5-1 is substituted by a different broker so long as the purchase or sales instructions remain the same.

Prohibition on overlapping plans and limitation on single-trade plans (but not for companies)

The final rule restricts anyone other than companies themselves from using multiple overlapping plans, although the SEC improved its original proposal in several ways, including the following:

- **Series of contracts treated as a single plan.** A series of separate contracts with different brokers may be treated as a single plan so long as the contracts taken together meet the conditions under the rule (but a modification of any contract would be treated as a modification of each other contract under the plan).
- **Overlapping plans that do not authorize trading during same period allowed under certain circumstances.** The final rule permits multiple concurrent Rule 10b5-1 plans if trading under a later commencing plan is not authorized until all trades under earlier-commencing plans are completed. However, where the first trade under a later-commencing plan is scheduled during what would have been the cooling-off period for that plan assuming the termination date of the earlier-commencing plan were deemed to be the date of adoption of the later-commencing plan, then Rule 10b5-1 would not be available for the later-commencing plan. The SEC reasons that this is to avoid an insider doing an end run around the cooling-off requirement since otherwise the insider could cancel the earlier plan before its scheduled termination and begin trading under the later plan before the end of the cooling-off period that is required for a new plan that is adopted after a plan termination.
- **"Sell-to-cover" tax withholding plans allowed.** In another welcome change from the rule proposal, the final rule authorizes a separate plan for purposes of "sell-to-cover" transactions under which the insider instructs their broker to sell securities to satisfy tax withholding obligations in connection with the vesting of incentive compensation. Notably, this exception does not apply to sell-to-cover in connection with option exercises, which the SEC views as subject to the insider's control.

Rule 10b5-1 would be available for only one "single trade" plan entered into by an insider during any 12-month period. In support of the limitation, the SEC cited a study that found that trades under such a plan "avoid losses that appear statistically unlikely to be avoided by uninformed traders" even where the trade occurs more than 120 days after plan adoption. The single-trade limitation also allows sell-to-cover transactions, mirroring the accommodation described above in the context of overlapping plans.

The SEC did not adopt limitations as proposed on multiple plans and single-trade plans for companies themselves.

Officer and director representations

Consistent with the proposed rule, the final rule provides that 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 that they are adopting the plan in good faith and not as part of a plan to evade the prohibition against illegal insider trading. Unlike the proposed rule, however, the final rule requires these certifications to be included as representations under the Rule 10b5-1 plan rather than a separate document provided to the issuer, and does away with a problematic recordkeeping requirement that was included in the proposed rule.

Good faith requirement

Currently Rule 10b5-1 trading plans must be adopted in good faith. The proposed rule would have added a requirement that they also be "operated" in good faith. The final rule requires instead that the person (including an issuer) who has adopted a Rule 10b5-1 plan must act in good faith with respect to the plan, and applies the requirement from the time of adoption through the duration of the plan. But because the distinction between operation of a plan in good faith and acting in good faith with respect to a plan is not clear, we think that this nevertheless raises questions around an insider's ability to terminate a plan, as well as the insider's later participation in authorizing corporate disclosure decisions.

Mandatory disclosure of trading plans and insider-trading policies

There is currently no requirement to publicly disclose the adoption, amendment or termination of a trading plan, and disclosure practice is mixed. In addition, companies are not currently required to publicly disclose the details of their insider-trading policies, and most do not. The final rule adds disclosure requirements for both and applies whether or not trading plans are entered into pursuant to Rule 10b5-1.

— **Quarterly disclosure of trading plans (but not pricing terms).** Consistent with the proposed rule, under the final rule a company would be required to disclose in its periodic reports (Forms 10-K and 10-Q, but not 20-F) any trading plans adopted or terminated by any officer or director during the previous quarter, whether or not adopted under Rule 10b5-1, along with a description of the material terms of the plans. The required disclosures include:
  - the name and title of officer or director,
  - 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.

Unlike the rule proposal, the final rule does not require disclosure of pricing terms.

The final rule also requires a company to disclose whether a trading arrangement is a Rule 10b5-1 trading arrangement or not, defines what qualifies as a non-Rule 10b5-1 trading arrangement and requires disclosure of the adoption or termination of such arrangements. The SEC definition of a non-Rule 10b5-1 trading arrangement is broad, and could potentially pick up any sale of securities by such officer or director.

In line with other aspects of the final rule, the SEC did not adopt its proposal to require disclosure of the use of trading arrangements by the company, and the disclosure obligations do not extend to traders other than officers or directors. However, the final rule does not exempt officers and directors of smaller reporting companies from the disclosure requirements.

— **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, and the company itself, that are reasonably designed to promote compliance with insider trading laws (or explain why not). These disclosures will be required in annual reports on Form 10-K, proxy and information statements on Schedules 14A and 14C and in Form 20-F. But rather than requiring disclosure of the issuer's policies and procedures within the body of the relevant report or statement, it requires the issuer to file a copy of their insider trading policies and procedures as an exhibit to the relevant form.

Although the quarterly disclosure of trading plans discussed above does not apply to foreign private issuers, the annual disclosure of insider-trading policies does. The SEC also highlighted in the adopting release that these disclosures will be subject to the certifications required by the Sarbanes-Oxley Act of 2002, requiring principal executive and financial officers to attest to the accuracy of the statements in Form 10-K or Form 20-F, as applicable (although the SEC does not reference Form 10-Q, the same point can be made for quarterly reports).

Gift reporting rules and other Form 4 and 5 changes

Reporting stock gifts on Form 4

Under existing rules, 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, by filing a Form 5.

The final rule, which was adopted as proposed, instead requires Section 16 insiders to report the donation (but not receipt) of company equity securities on Form 4 within two business days. The requirement covers all recipients, including family members, trusts and other estate planning vehicles and Section 501(c)(3) charitable organizations. The SEC reiterated its view that the reporting change is to allow investors to evaluate gift transactions in light of potential "problematic" practices, including stock gifts while the donor is in possession of MNPI, or backdating stock gifts to maximize the donor's tax benefit. Insiders may wish to plan their year-end gift-giving for 2023 early to manage the associated compliance and administrative burdens.

Although we had raised this concern in our comment letter, the SEC did not address its claim in the proposing release that a donor of securities violates insider trading laws if the donor, "in fraudulent breach of a duty of trust and confidence," gifts securities when the donor was aware of MNPI and knew or was reckless in not knowing that the donee would sell the securities prior to the public disclosure of the MNPI. This language appears to represent an extension of existing insider trading law that calls into question the commonplace activity of year-end gifting while in a company blackout period, and the SEC does not cite judicial precedent or other authority for this proposition. While the SEC suggests that the affirmative defense is available when a donor gifts under a Rule 10b5-1 plan, it still leaves unclear what it believes to be a violation, or a gift "in fraudulent breach of a duty of trust and confidence." Absent future clarification on the point, we are left wondering if the SEC's view is that a gift outside a Rule 10b5-1 plan but in compliance with a company's insider trading policy by a donor who may be aware of MNPI could potentially violate insider trading laws.

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 views of the company's near-term prospects.

The final rule adds a mandatory checkbox to Forms 4 and 5 indicating whether the transaction was *intended to satisfy the affirmative defense conditions* under, rather than *made* (as formulated in the proposal), pursuant to a Rule 10b5-1 trading plan to address a concern around reporting persons having to make the determination about whether the transaction was in fact made pursuant to the plan. The SEC did not adopt the 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 as it was persuaded by commenters that such an optional checkbox would not add to the information already disclosed in the relevant form.

Option grant disclosure

As proposed, the final rule targets company practices that time option grants around the release of MNPI, with a focus on so-called "spring-loaded" and "bullet-dodging" option grants. The final rule requires a company to provide narrative disclosure in 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.

The final rule requires 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 made in the four business days before the filing of a periodic report (Form 10-K or 10-Q) or reporting of MNPI on Form 8-K (including earnings, but excluding a Form 8-K that is filed to disclose a material option grant under Item 5.02(e)) and ending one business day after a triggering event (narrowing the 14 calendar-day window before or after such filing or reporting in the proposed rule, or what was effectively a period of 28 calendar days for each issuance of MNPI).

Disclosure will still be required in tabular format (though somewhat more simplified than in the proposed rule), tagged in Inline XBRL, and must include for each named executive officer, on an-award-by-award basis:

- the date of grant,
- the number of shares underlying the award,
- the exercise price,
- the grant date fair value of the award, and
- the percentage change in the market price of the underlying shares between the closing market price on the trading day before and the trading day after disclosure of the MNPI (combining the final two columns in the proposed rule into a single column).

Unlike the rule proposal, the final rule removes adoption of a stock buyback plan as a disclosure trigger.

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.

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