June 10, 2021

Skadden

SEC Reporting & Compliance Alert

If you have any questions regarding the matters discussed in this memorandum, please contact the following attorneys or call your regular Skadden contact.

Katherine D. Ashley
Partner / Washington, D.C.
202.371.7706
katherine.ashley@skadden.com

Brian V. Breheny
Partner / Washington, D.C.
202.371.7180
brian.breheny@skadden.com

Raquel Fox
Partner / Washington, D.C.
202.371.7050
raquel.fox@skadden.com

Caroline S. Kim
Counsel / Washington, D.C.
202.371.7555
caroline.kim@skadden.com

This memorandum is provided by Skadden, Arps, Slate, Meagher & Flom LLP and its affiliates for educational and informational purposes only and is not intended and should not be construed as legal advice. This memorandum is considered advertising under applicable state laws.

One Manhattan West
New York, NY 10001
212.735.3000

1440 New York Avenue, N.W.
Washington, D.C. 20005
202.371.7000

SEC Chair Gensler Previews Potential Changes for Rule 10b5-1 Plans

On June 7, 2021, in prepared remarks for the CFO Network Summit, Securities and Exchange Commission (SEC) Chair Gary Gensler identified several areas of focus for SEC staff with respect to Rule 10b5-1 under the Securities Exchange Act of 1934, as amended (Exchange Act). These remarks provide insight regarding potential future rulemaking.

Rule 10b5-1, adopted in 2002, provides a mechanism for individuals and entities to make scheduled trades over a period of time, provided that the plan directing those trades is entered into at a time when the individual or entity does not possess material nonpublic information about the company or securities that are traded under the plan. Trades under an effective Rule 10b5-1 plan can benefit from an affirmative defense to an insider trading challenge. Rule 10b5-1 plans have become common features of issuer repurchase programs and are utilized by many corporate insiders and other individuals seeking to structure trades over a period of time and avoid the risk of being unexpectedly prevented from trading due to the possession of material nonpublic information.

Chair Gensler specifically identified four concerns with Rule 10b5-1 plans under the current law and practice:

1. **Rule 10b5-1 does not require a cooling-off period between the time the plan is entered into and the time of the first trade.**

   While a cooling-off, or waiting, period is a common feature of many Rule 10b5-1 plans, and a common requirement of issuers who adopt guidelines for insiders utilizing Rule 10b5-1 plans, the length of such period varies, and there is no requirement under the existing rule for any waiting period. Chair Gensler noted that recommendations to require a four to six month waiting period have received bipartisan support from a former SEC chair and current commissioners, and that such recommendations warrant renewed consideration. Notably, a four to six month waiting period is longer than what many practitioners consider the current best practice.

   Chair Gensler also noted that not having a cooling-off period could be perceived as a "loophole to participate in insider trading." His remarks do not elaborate on how a loophole is created by the lack of a cooling-off period, when the trading decision and instruction is implemented at a time when the individual or entity does not have material nonpublic information. The SEC has been clear that an insider cannot be "cleansed" of having possessed material nonpublic information by the release of that

© Skadden, Arps, Slate, Meagher & Flom LLP. All rights reserved.

information prior to the first trade under a Rule 10b5-1 plan. Accordingly, many practitioners and companies take the view that a waiting period offers beneficial optics but potentially limited substantive protection. Chair Gensler cited recent empirical research suggesting more favorable returns result from trades under plans with little to no cooling-off period.[1]

2. Rule 10b5-1 plans can be terminated even when the entity or individual terminating the plan has material nonpublic information.

Chair Gensler expressed concern that Rule 10b5-1 plans can be canceled by an entity or individual in possession of material nonpublic information, calling the opportunity "upside-down," since "canceling a plan may be as economically significant as carrying out an actual transaction."

Prior SEC guidance, including in Compliance and Disclosure Interpretations issued by the Division of Corporation Finance, noted that Exchange Act Section 10(b) and Rule 10b5-1 apply to any fraudulent conduct "in connection with the purchase or sale of any security," and therefore a securities transaction is required in order for liability to exist. By definition, a termination of a trading plan results in no such securities transaction. As Chair Gensler notes, and practitioners have long advised, even if a termination is permitted, a termination can be used as evidence of a lack of good faith in establishing the plan, and thereby create a potential avenue to challenge the affirmative defense provided by Rule 10b5-1. For this reason, many practitioners advise caution and restraint in terminating Rule 10b5-1 plans.

3. Rule 10b5-1 does not require public disclosure of such plans.

Chair Gensler notes that "more disclosure regarding the adoption, modification, and terms of Rule 10b5-1 plans by individuals and companies could enhance confidence in our markets." While some issuers and individuals do voluntarily disclose adoption of a Rule 10b5-1 plan (for example in a Form 8-K or the individual's Form 4), and Schedule 13D filers may be required to do so, detailed disclosure about the terms of Rule 10b5-1 plans is rare. If an issuer were required to disclose the cap at which it will repurchase its stock, or an insider were required to disclose the minimum price for a sale, the market could perceive these limits as reflecting a long-term view of the stock, and any such required disclosure may deter use of Rule 10b5-1 plans.

4. There are no limits on the number of 10b5-1 plans that an insider can adopt.

Chair Gensler commented that "[w]ith the ability to enter into multiple plans, and potentially to cancel them, insiders might mistakenly think they have a 'free option' to pick amongst favorable plans as they please."

Rule 10b5-1 in its current form does not allow multiple plans to cover the same shares of stock, or permit the cancellation of one plan to influence the trading that occurs under another plan. Additionally, an insider may have legitimate reasons to utilize multiple plans, such as having one plan for an extended term to direct sales sufficient to cover tax liabilities upon vesting of equity grants, and another plan to cover certain discrete trades for diversification purposes.

Next Steps

Proposals relating to Rule 10b5-1 reforms have periodically surfaced since its adoption 20 years ago,[2] including proposals highlighting many of the same issues identified by Chair Gensler, as well as the intersection of the rule with share repurchases. Several of these themes also appear in recent legislation introduced in Congress, which would require the SEC to study Rule 10b5-1.[3] Given the increased scrutiny of Rule 10b5-1 activity, we anticipate that the SEC staff will act quickly to make recommendations to the commission and that a rulemaking proposal and request for public comment will be forthcoming.

[1] *See* David F. Larcker, Bradford Lynch, Phillip Quinn, Brian Tayan and Daniel J. Taylor, "Gaming the System: Three 'Red Flags' of Potential 10b5-1 Abuse" (Jan. 19, 2021).

[2] See, *e.g.*, our discussion of rulemaking proposals submitted to the SEC by the Council of Institutional Investors regarding some of the same concerns in our client alert "Getting Back to Basics With Rule 10b5-1 Trading Plans" (April 9, 2013).

[3] See, *e.g.*, the Promoting Transparent Standards for Corporate Insiders Act (H.R. 1528) passed by the U.S. House of Representatives on April 20, 2021, which would direct the SEC to study and report on possible revisions to Rule 10b5-1 and undertake rulemaking consistent with the results of such study, and the Insider Trading Prohibition Act (H.R. 2655) passed by the U.S. House of Representatives on May 18, 2021, which would codify the definition of illegal insider trading under the securities laws.