Congress and SEC Contemplate Modifying 10b5-1 Insider Trading Plans

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On June 7, 2021, during prepared remarks delivered at the CFO Network Summit, SEC Chair Gary Gensler announced that he asked SEC Staff to focus closely on reforms to Exchange Act Rule 10b5-1. These reforms would scale back what Chairman Gensler believes are potential abuses by public company executives and directors in the use of 10b5-1 trading plans. Furthering scrutiny on Rule 10b5-1, Senators Chris Van Hollen (D-MD) and Deb Fischer (R-NE) have introduced legislation requiring the SEC to conduct research into the efficacy of potential changes to Rule 10b5-1.[1] The Act has not yet been put to a vote in the Senate, but the House passed a version of the bill on April 22, 2021.[2]

What is Rule 10b5-1?

Rule 10b5-1 creates a safe harbor for corporate insiders who buy or sell securities in a publicly-traded company about which the insider possesses material nonpublic information. Thus, Rule 10b5-1 provides an affirmative defense for insiders by allowing them to trade securities as long as certain conditions are satisfied before an insider becomes aware of material nonpublic information. Prior to such awareness, insiders have three potential 10b5-1 safe harbors permitting them to trade in a company: if an insider has (1) entered into a contract to trade a security, (2) instructed another party to trade a security for the insider, or (3) adopted a written plan for trading securities, then Rule 10b5-1 provides the insider with certainty of a defense against liability. However, Rule 10b5-1 is a good faith defense that can be defeated, if, for example, the insider exercised influence about whether to purchase securities under a plan following the plan's adoption. As a result, the tactics discussed below already have the possibility of weakening or defeating a 10b5-1 defense if there is a sufficient showing of impropriety. These are tactics that the Act and the SEC may seek to eliminate entirely.

How do proposed changes seek to modify Rule 10b5-1?

Rule 10b5-1 plans have faced scrutiny since their adoption in 2002. The Act and Chairman Gensler echo these concerns. For example, 14% of planned trades happen within a month of a plan's adoption and 40% within two months of adoption.[3] Thus, both Chairman Gensler and the Act contemplate a "cooling-off period" following the adoption of a plan. Proposed cooling-off periods have included four and six-month time frames. A similar problem with 10b5-1 plans under current requirements is that insiders can cancel a plan at any time. Both Chairman Gensler and the Act suggest limiting plan cancellation because cancellation can be as "economically significant" as plan adoption. If an insider is in possession of material nonpublic information that would be expected to hurt the value of a security, the insider can cancel a planned purchase of the security, thereby

avoiding a loss. Similarly, if the information's release is likely to boost the price of a security, the insider could cancel a planned sale. Yet, the more often an insider cancels planned sales, the weaker the 10b5-1 defense becomes for that insider, if challenged.

Further, insiders have no duty to disclose information regarding adoption, modification, or termination of trading plans. Chairman Gensler publicly stated that he believes a disclosure requirement would "enhance confidence in our markets," and the Act would require the SEC to inquire into the effectiveness of a disclosure system. Thus, a system of mandatory disclosure could be on the horizon.

Finally, the SEC and the Act could lead to a limitation on the number of trading plans that an insider can adopt. There is technically no limit on the number of 10b5-1 plans an insider can adopt, so an insider could utilize several concurrent trading plans at once. Yet, this raises suspicion that a corporate insider is attempting to avoid 10b5-1's requirements. Thus, this tactic is legally suspect, especially as the number of trading plans increases, and should be avoided. Accordingly, it is best practice to have only a single plan in place at any time. Single plans may allow for varying sales or purchases based on preset conditions that are met when a plan is adopted. As a result, single plans can accomplish the benefits of multiple plans while avoiding the legal suspicion that accompanies multiple plans.

The Act also proposes two inquires exclusive of Chairman Gensler's suggestions. The Act would also have the SEC evaluate whether limiting the frequency of adoption or modification of trading plans would reduce insider trading. Similarly, it would contemplate whether corporate boards themselves should be mandated to adopt policies regarding insider trading plans. While limiting the modification of plans is similar to some of the changes that Chairman Gensler proposes, requiring corporate boards to adopt policies regarding these plans could require enhanced scrutiny on corporate boards as collective bodies.

While Rule 10b5-1 remains a valuable tool for corporate insiders, congressional and regulatory reforms could limit some of the outermost activities covered by the Rule. Thus, corporate insiders should be aware of enhanced scrutiny on insider trading, keep up to date on any proposed changes to Rule 10b5-1, exercise caution when adopting Rule 10b5-1 trading plans, and keep in mind an SEC that appears to be keen on cracking down on what is or what looks like insider trading.

This Kelley Drye client advisory was written with the assistance of summer associate Jonas Hallstein.

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[1] *See* Promoting Transparent Standards for Corporate Insiders Act, 117th Cong. ___ (2021), available at https://www.vanhollen.senate.gov/imo/media/doc/EHF21695.pdf (hereinafter the "Act").
[2] *See* Promoting Transparent Standards for Corporate Insiders Act, H.R. 1528., 117th Cong. (2021).
[3] Cydney Posner, Gensler Plans to "Freshen Up" Rule 10b5-1, Harv. L. School F. Corp. Governance (2021).