The SEC's run at revamping Rule 10b5-1 to deter insider trading

By Jonathan D. Uslaner, Esq., and Caitlin C. Bozman, Esq., Bernstein Litowitz Berger & Grossmann LLP

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On Dec. 14, 2022, the Securities and Exchange Commission ("SEC") issued a final rule amending Rule 10b5-1, with the amendments set to take effect on Feb. 27, 2023. The SEC claims that these amendments will more forcefully deter improper insider trading — i.e., buying or selling a company's securities based on material nonpublic information. It remains to be seen whether the amendments will achieve their intended goal.

Rule 10b5-1 plans and how they work

The SEC enacted Rule 10b5-1 in 2000 to clarify the prohibition on insider trading by corporate insiders. Over the past two decades, insiders have increasingly attempted to sidestep the prohibition by adopting "Rule 10b5-1 trading plans." Under such plans, insiders do not have direct control over their individual trades. Instead, trades are made pursuant to a predetermined plan, which specifies a formula or other fixed metric for determining the price, amount, and dates of the insider's stock sales.

The recent amendments to Rule 10b5-1 fall into two categories: additional restrictions on Rule 10b5-1 trading plans, and new disclosure requirements.

Rule 10b5-1 plans have gained widespread popularity among corporate insiders. The SEC reported that during 2021, approximately 5,800 officers and directors at 1,600 companies traded under Rule 10b5-1 plans. (Insider Trading Arrangements and Related Disclosures, 87 Fed. Reg. 80362, 80397 (Dec. 29, 2022)). The actual number of trades is likely much larger because Rule 10b5-1 does not expressly require corporations or insiders to disclose the adoption, modification, or terms of Rule 10b5-1 plans or trades thereunder. The SEC's estimate thus relies on disclosures required by other provisions of the federal securities laws.

Insiders may avoid liability for insider trading if they adopt a Rule 10b5-1 plan that meets certain requirements. To benefit from Rule 10b5-1's protections under current law, the insider must enter their trading plan in "good faith" and before they become privy to material non-public information. If the insider does not enter the plan in "good faith," or enters the plan after receipt of insider information, then Rule 10b5-1 provides them no protection — and they still may be liable for insider trading.

Gaps in the current Rule 10b5-1 have enabled insiders to make millions of dollars trading based on material non-public information, while still using Rule 10b5-1 to avoid prosecution. The SEC claims that the newly issued amendments to Rule 10b5-1 will close these gaps.

How the SEC's amendments will change Rule 10b5-1

The recent amendments to Rule 10b5-1 fall into two categories: additional restrictions on Rule 10b5-1 trading plans, and new disclosure requirements. The amendments ostensibly aim to close existing gaps in the rule and require companies to provide outside investors with information about certain insiders' trading plans.

Cooling-off period. Under the amendments, Rule 10b5-1 plans now must include a "cooling-off period" — i.e., a period following plan adoption or amendment, during which the insider cannot trade. For corporate officers and directors, the cooling-off period prohibits trading under a plan until the later of (i) 90 days following plan adoption or modification, and (ii) two business days following the company's public disclosure of its financial results. For other insiders, the cooling-off period is 30 days.

The SEC based the new cooling-off period, in part, on an academic study prepared by The Wall Street Journal. The study — "CEO Stock Sales Raise Questions About Insider Trading," June 29, 2022 — showed that improper insider trading often occurs within the first 90 days after an insider adopts or modifies a 10b5-1 trading plan. The new cooling-off period also accounts for the fact that improper insider trading often takes place shortly before the company publicly releases its financial results.

Although the cooling-off period may incrementally deter insider trading, it likely will prove insufficient. A study published in the Stanford Closer Look Series (and cited by the SEC in the amendments) concluded that relevant data supported a longer cooling-off period of four to six months. ("Gaming the System: Three 'Red Flags' of Potential 10b5-1 Abuse," Stanford Closer Look Series, Jan. 19, 2021.)

This proposal received support from a wide range of commenters, but the SEC instead credited concerns that a four-to-six-month cooling-off period was "unnecessarily long" and ultimately shortened the cooling-off period to just 90 days.

Officer and director certifications. The SEC's recent amendments to Rule 10b5-1 also require officers and directors to certify under oath that they were not aware of material non-public information when they adopted or amended their trading plan. It is far from clear whether the certification requirement will actually deter improper insider trading, which often involves intentional misconduct.

Critics have raised concerns about the efficacy of certification requirements under the federal securities laws, such as the Sarbanes-Oxley Act's requirement that the CEO and CFO certify the company's financial reports. These critics contend that there is scant empirical evidence to support the actual or perceived efficacy of certification requirements.

Although certain aspects of the amendments to Rule 10b5-1 may deter insider trading, the overall effectiveness of the amendments remains to be seen.

For example, a study evaluating perceived efficacy, published in the International Journal of Auditing, found that respondents across corporate constituencies believe that top executives routinely certify financial statements without the necessary information to make a knowledgeable certification. ("The Perceived Effectiveness of the Officer Certification requirement under Sarbanes-Oxley," International Journal of Auditing, June 15, 2011.)

Restrictions on multiple, overlapping and single-trade plans. The SEC's recent amendments to Rule 10b5-1 generally prohibit corporate officers and directors from using multiple, overlapping Rule 10b5-1 trading plans. This general prohibition addresses a significant loophole in the current Rule 10b5-1, which permits insiders to adopt multiple trading plans and selectively cancel certain plans based on material nonpublic information. Such arrangements have been in the SEC's crosshairs for years, with SEC Chair Gary Gensler cautioning that this trading strategy employed by certain insiders enabled them to end-run the requirements of Rule 10b5-1. (Prepared Remarks, CFO Network Summit, June 7, 2021.)

The SEC's amendments to Rule 10b5-1 also limit insiders' use of "single-trade plans," which involve a one-off, often large sale of an insider's stock in their company. Research cited by the SEC suggests that single-trade plans have a high potential for abuse. (Insider Trading Arrangements and Related Disclosures, 87 Fed. Reg. 80362, 80370 n.112 (Dec. 29, 2022)). The SEC's amendments seek to stop such abuse by prohibiting insiders from adopting more than one "single-trade plan" in any 12-month period.

Critics have observed, however, that the amendment's restriction on "single-trade plans" do not go far enough. According to these critics, the amendments fall short of closing the existing gap under Rule 10b5-1 because they do not completely bar single-trade plans.

Strengthening the 'good faith' requirement. The SEC's recent amendments meaningfully strengthen Rule 10b5-1's existing "good faith" requirement. Prior to the amendments, Rule 10b5-1 required insiders to act in good faith when entering into or amending a trading plan.

Under the amendments, companies and insiders may only benefit from Rule 10b5-1's protection against liability for insider trading if they act in good faith with respect to their trading plans *at all times* — i.e., not just when entering into or amending such plans. This change to the good faith requirement makes explicit that Rule 10b5-1 will not protect insiders who exploit loopholes in the rule or otherwise misuse their trading plans.

New disclosure requirements. The SEC's amendments also require companies to publicly disclose certain information about insiders' use of trading plans. Under the new Item 408(a), companies now must disclose the adoption, modification, or termination, and the material terms of trading plans (including certain non-Rule 10b5-1 plans) held by directors and certain officers.

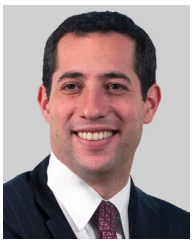
Companies also must disclose their policies and procedures governing insider trading. This disclosure obligation should improve visibility into how public companies handle insider trading and will provide additional insight into whether companies or their insiders are improperly using Rule 10b5-1 trading plans to evade the requirements of the rule.

Conclusion

Although certain aspects of the amendments to Rule 10b5-1 may deter insider trading, the overall effectiveness of the amendments remains to be seen. Ideally, where the amendments to trading plans fall short, the new disclosure requirements will better enable investors and other industry watchdogs to ferret out insider misuse of Rule 10b5-1 and other trading plans.

Jonathan D. Uslaner is a regular contributing columnist on securities litigation for Reuters Legal News and Westlaw Today.

About the authors



Jonathan D. Uslaner (L) is a partner at **Bernstein Litowitz Berger & Grossmann LLP**, where he prosecutes class and direct actions on behalf of institutional investor clients. He is based in the firm's Los Angeles office and can be reached at jonathanu@blbglaw.com. **Caitlin C. Bozman** (R) is an associate at the firm. Based in the Los Angeles office, she prosecutes securities fraud, corporate governance, and shareholder rights litigation on behalf of institutional investor clients. She can be reached at caitlin.bozman@blbglaw.com.

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