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SEC Rule 10b5-1 Trading Plans

Recent Lessons and Likely Reforms to Come

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Introduction

Last month, the U.S. Securities and Exchange Commission ("SEC") released its 2021 regulatory agenda that included the affirmative defense provisions of Rule 10b5-1 among the areas in which the agency may take additional rulemaking action.[1] This release followed an announcement by SEC Chairman Gary Gensler ("Gensler") on June 7, 2021, that he had directed SEC staff to consider both tougher restrictions on securities trading by corporate insiders pursuant to Rule 10b5-1 trading plans and increased transparency for such trading. Gensler expressed his concern that abuse of Rule 10b5-1 plans has led to a gap in insider trading laws and undermines investor confidence in the markets.[2]

Rule 10b5-1 provides officers, directors, public company insiders, and businesses with an affirmative defense to insider trading claims, even if they are in possession of material nonpublic information at the time of their stock trades, provided that the trades were made pursuant to a plan adopted when they did not possess material nonpublic information.[3] The rule was intended to allow corporate insiders to trade in their company's securities while at the same time affording other market participants confidence that insiders were not benefitting based on access to material, nonpublic information.

However, Rule 10b5-1 trading plans have been the subject of criticism in the media and on Capitol Hill following several notable cases of company executives appearing to benefit from buying or selling company stock ahead of major public announcements impacting the stock value. Similarly, concerns have been raised over the relationship between Rule 10b5-1 and corporate stock repurchases. It now appears the SEC is poised to address these concerns and institute reforms to Rule 10b5-1 trading plan requirements soon. In the meantime, the SEC staff is scrutinizing 10b5-1 plans to ensure they comply with existing requirements. Companies and executives should plan accordingly now to confirm their Rule 10b5-1 trading plans are consistent with current SEC requirements and best practices.

Background of Rule 10b5-1

The SEC adopted Rule 10b5-1 in 2000 and addressed the issue of when insider trading liability arises in connection with a trader's "use" versus "knowing possession" of material nonpublic information.[4] The rule originated in light of conflicting court rulings regarding the standard for finding insider trading liability in violation of Rule 10b-5 – whether liability would apply only when the insider was found to have "used" the nonpublic information or when the insider was merely in possession of the nonpublic information.[5] Rule 10b5-1(b) clarified that trades were made "on the basis of" material

[1] SEC Announces Annual Regulatory Agenda (June 11, 2021), https://www.sec.gov/news/press-release/2021-99.

[2] Gary Gensler, Chairman, SEC, Prepared Remarks at CFO Network Summit ("Gensler Announcement") (June 7, 2021), https://www.sec.gov/news/speech/gensler-cfo-network-2021-06-07.

[3] 17 C.F.R. § 240.10b5-1.

[4] *See* Final Rule: Selective Disclosure and Insider Trading, SEC Release No. 33-7881; 17 C.F.R.240.10b5-1, https://www.sec.gov/rules/final/33-7881.htm.

[5] Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder prohibit, among other things, "the purchase or sale of a security of any issuer, on the basis of material nonpublic information about that security or issuer, in breach of a duty of trust or confidence that is owed

nonpublic information if the person making the purchase or sale was aware of the material nonpublic information when the person made the purchase or sale. At the same time it adopted this more exacting standard, the SEC also created an affirmative defense to an insider trading charge under Rule 10b-5 for any person who traded pursuant to a so-called Rule 10b5-1 plan. A Rule 10b5-1 plan is a written plan setting forth when a corporate insider's securities will be purchased or sold in the future according to a predetermined formula. These plans, when properly implemented, protect corporate insiders and others that may gain access to material nonpublic information about an issuer's securities from regulatory and litigation risk, provide opportunities to sell shares unrestricted by blackout periods, and decrease the uncertainty often accompanying determinations of whether an executive or entity is free of material, nonpublic information when trading securities.

In order to benefit from the affirmative defense set forth in Rule 10b5-1, a Rule 10b5-1 plan must meet the following requirements:

- The plan must be established in good faith when the participant is not aware of inside information.
- The plan must specify the number of securities to be traded, at which price the securities are to be traded, and the date on which securities are to be traded, or it must include a formula for making such determinations.
- A participant is prohibited from exercising any subsequent influence over how, when, or whether to effect purchases.[6]

A Rule 10b5-1 plan can be tailored to an individual's liquidity needs, an individual's investment goals, or an issuer's stock ownership guidelines. A corporation that is interested in buying back its own stock may also set up a Rule 10b5-1 plan to repurchase shares in the future. Rule 10b5-1 does not generally require the participant to disclose the plan's existence, although many issuers choose to do so in an attempt to manage market reaction to insider transactions.[7]

Rule 10b5-1 does not limit the amount or type of securities a Rule 10b5-1 plan may cover. Likewise, Rule 10b5-1 does not limit the term of a Rule 10b5-1 plan, or the number of Rule 10b5-1 plans that can be adopted or terminated. Although many insiders will wait for a period of time to pass following the adoption of a Rule 10b5-1 and before execution of the first trade under the plan in order to avoid the appearance that the trades were based on material, nonpublic information, there is no mandatory waiting period imposed by the rule.

Modification of a Rule 10b5-1 plan is permitted, so long as the individual or entity does not possess material nonpublic information at the time of the modification, is acting in good faith, and otherwise complies with the elements of the rule. Plans may be cancelled at any time. However, such changes may jeopardize the availability of the affirmative defense by creating the appearance that the Rule 10b5-1 plan is being manipulated by its holder. In order to avoid such scrutiny, many Rule 10b5-1 plans are designed to automatically terminate or suspend trading in certain predefined circumstances.

Recent Media Reports of Controversial Insider Sales and Calls to Revise Rule 10b5-1

Multiple insider stock transactions, many of them pursuant to Rule 10b5-1 plans at companies involved with creating and manufacturing COVID-19 vaccines, generated substantial media attention, as well as scrutiny on Capitol Hill. For example, *The Wall Street Journal* reported that executives and directors at 13 pharmaceutical companies collectively sold approximately $496 million of stock in 2020 allegedly "reaping rewards of positive vaccine developments that drove up the value of the drugmakers' shares."[8] By comparison, executives and directors of those companies sold about $132 million of stock in 2019. According to the articles, many of the Rule 10b5-1 trading plans used to direct such trading across the various companies were established after the pandemic hit and when vaccines were already being developed.

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directly, indirectly, or derivatively, to the issuer of that security or the shareholders of that issuer, or to any other person who is the source of the material nonpublic information." Rule 10b5-1(a).

[6] *See* 17 C.F.R. § 240.10b5-1(c).

[7] In the case of restricted stock sales under a 10b5-1 plan, the adoption date of the plan is disclosed on SEC Form 144.

[8] Inti Pacheco, *Insiders at Covid-19 Vaccine Makers Sold Nearly $500 Million of Stock Last Year*, WALL ST. J., (Feb. 17, 2021), https://www.wsj.com/articles/insiders-at-covid-19-vaccine-makers-sold-nearly-500-million-of-stock-last-year-11613557801; *See also*, Jared S. Hopkins and Gregory Zuckerman, *Pfizer CEO Joins Host of Executives at Covid-19 Vaccine Makers in Big Stock Sale*, WALL ST. J., (Nov. 11, 2020), https://www.wsj.com/articles/pfizer-ceo-joins-host-of-executives-at-covid-19-vaccine-makers-in-big-stock-sale-11605139164?mod=article_inline.

The media reports of insider transactions attracted attention from legislators on Capitol Hill. On February 10, 2021, U.S. Senators Elizabeth Warren, Sherrod Brown, and Chris Van Hollen wrote a letter to then-SEC Acting Chair Allison Herren Lee urging her to review and reform SEC policies regarding 10b5-1 plans.[9] The Senators stated that "these plans were designed to prevent insider trading, but new evidence indicates that executives – especially those in the healthcare industry – are abusing these plans to obtain huge windfalls at the expense of ordinary investors."[10] The Senators cited media reports indicating that on the same day Pfizer announced its COVID-19 vaccine was found to be more than 90% effective in clinical trials, Pfizer's CEO sold more than 60% of his personal shares in the company, valued at roughly $5.6 million, under a 10b5-1 plan. They also cited research stating that "although trades under 10b5-1 plans are intended to be set months in advance, it is not unusual for the plans to be modified days or hours before a major public announcement" and referenced a report that the plan of Pfizer's CEO was modified just one day before Pfizer announced the result of the first phase of its clinical trial.[11] They further expressed concern over research suggesting that initial trades under 10b5-1 plans often appear to be based on material nonpublic information and that executives can and do modify or cancel their plans in response to insider information in order to increase their own profits. The senators specifically called for imposition of mandatory waiting periods to trade after adopting or modifying a Rule 10b5-1 plan as well as public disclosure of the adoption, modification, and trading with respect to 10b5-1 plans.

Then-acting SEC Chair Lee responded to the letter by expressing support for agency consideration of the suggested reforms.[12] Acting Chair Lee explained that she instructed SEC staff to review Rule 10b5-1 and develop recommendations for possible changes, including those put forth by the Senators. She also warned that the Division of Enforcement will continue to evaluate, as appropriate, 10b5-1 plans during its investigations.

On April 27, 2021, Senator Warren sent an additional letter to new SEC Chair Gensler reiterating her concerns about 10b5-1 plans and specifically asking the SEC to open an investigation into trading in Emergent BioSolutions ("Emergent") securities by Emergent's CEO and other executives.[13] Senator Warren cited media reports indicating that in March 2021, Emergent, a government contractor that produced the Johnson and Johnson COVID-19 vaccination, revealed that production issues in one of its plants ruined approximately 15 million doses of vaccine.[14] This revelation was followed by a precipitous decline in the price of Emergent shares. The media stories revealed that Emergent's CEO had previously sold more than $10 million worth of stock in the company during January and early February 2021, his first substantive stock sales in nearly five years. According to the reports cited by Senator Warren, the stock sales were the result of exercising stock options he had previously received as part of his compensation package, and are said to have been done pursuant to a Rule 10b5-1 trading plan. In calling for an investigation of Emergent's executives, Senator Warren alleged that before Emergent's CEO adopted his trading plan in November 2020, he had ample information about production problems at Emergent, which may have stretched at least as far back as April 2020.

Most recently, on July 15, 2021, lawmakers in the House and Senate reintroduced legislation in both chambers aimed at closing what some consider to be an insider trading loophole by directing the SEC to issue rules requiring public issuers to prohibit executive officers and directors from trading the issuer's securities during the period between a significant corporate event and the filing of an 8-K disclosing the event.[15] Referred to as the 8-K Trading Gap Act, the bill passed the House last year but did not advance in the Senate at that time. The bill is named after a 2015 study co-authored by former SEC Commissioner Robert J. Jackson Jr. titled the "8-K Trading Gap" which found statistically significant returns on stock

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[9] Letter from Senators Elizabeth Warren, Sherrod Brown and Chris Van Hollen to the Hon. Allison Herren Lee (Feb. 10, 2021), https://www.warren.senate.gov/download/02102021-letter-from-senators-warren-brown-and-van-hollen-to-acting-chair-lee.

[10] *Id*. at 1.

[11] *Id.* at 2 *citing* Tom Dreisbach, *Pfizer CEO Sold Millions In Stock After Coronavirus Vaccine News, Raising Questions*, NPR (Nov. 11, 2020), https://www.npr.org/2020/11/11/933957580/pfizer-ceo-sold-millions-in-stock-after-coronavirus-vaccine-news-raising-questio.

[12] Letter from Acting Chair Allison Herren Lee to Senator Elizabeth Warren, ("Lee Letter") (Apr.14, 2021) https://www.warren.senate.gov/download/warren-et-al_-rule-10b5-1_-es159896-response.

[13] Letter from Senator Elizabeth Warren to the Hon. Gary Gensler (Apr. 27, 2021), https://www.warren.senate.gov/download/20210427-letter-to-sec-re-emergency-ceo-stocks.

[14] *Id.*, *citing* John Swaine, *CEO of vaccine maker Emergent sold $10 million in stock before company ruined Johnson & Johnson doses*, WASH. POST (April 25, 2021), https://www.washingtonpost.com/investigations/emergent-robert-kramer-stock-sales/2021/04/25_/de151434-a2b6-11eb-a7ee-949c574a09ac_story.html.

[15] Democrats Rep. Carolyn Maloney, a member of the House Financial Services Committee, and Sen. Chris Van Hollen, a member of the Senate Banking Committee, reintroduced the bill in their respective chambers. *See* 8-K Trading Gap Act, S. ____, 117th Cong. (2021).

sales executed between events such as bankruptcies, mergers and acquisitions, regulatory and criminal investigations, and changes in leadership, and the filing of a Form 8-K publicly announcing the event. If successfully passed, the law will further tighten restrictions on corporate insiders' ability to trade while in possession of material, nonpublic information, by prohibiting trading, regardless of intent, during such time frames. Although the proposed legislation permits certain exceptions, it expressly prohibits trades made pursuant to certain 10b5-1 plans adopted shortly before the filing of an 8-K.

SEC Enforcement Focus on Rule 10b5-1 Trading Plans

Insider trading cases continue to be a core focus of the SEC's Division of Enforcement. At the start of the COVID-19 pandemic, the SEC's then Co-Directors of Enforcement warned corporate insiders to take special care to avoid trading based on material nonpublic information.[16] They also urged public companies to be mindful of established controls to prevent the misuse of material nonpublic information including prohibitions on insider trading. During the height of the pandemic, then-SEC Chairman Jay Clayton publicly supported a mandatory cooling-off period between adoption or modification of a Rule 10b5-1 plan and trading pursuant to a Rule 10b5-1 plan.[17]

Yet, thus far the SEC has brought few enforcement actions over trading linked to a Rule 10b5-1 plan. That is likely to change under the new Commission leadership, given Gensler's statement that current Rule 10b5-1 plans "have led to real cracks in our insider-trading regime."[18] Indeed, late last year, the Division of Enforcement conducted an investigative sweep issuing subpoenas for information on both executives' Rule 10b5-1 plans and company policies and procedures for those plans. This sweep may result in public enforcement actions intended to serve as examples of violations of existing rules and provide further context for SEC amendments to Rule 10b5-1 procedures in the future.

Intersection of Rule 10b5-1 Plans and Corporate Buybacks

Companies, like individual insiders, may establish Rule 10b5-1 plans through which to buy back corporate stock. Likewise, to avail themselves of any potential affirmative defense afforded by Rule 10b5-1, they must act in good faith and avoid establishing a plan while in possession of material nonpublic information. Whether a company is acting to repurchase stock at a low price ahead of a public announcement expected to boost the stock price is a concern to regulators and other investors and a situation that Rule 10b5-1 is theoretically designed to prevent. Regulators have also expressed concern about whether corporate insiders may have material nonpublic information about corporate stock repurchases when the insiders adopt their own Rule 10b5-1 plans.

On October 15, 2020, the SEC issued a somewhat unusual but instructive settled administrative order charging Andeavor LLC with failing to devise and maintain adequate internal controls surrounding its buyback of company stock pursuant to a Rule 10b5-1 plan.[19] Notably, the SEC charges were based on the company's failure to follow its own policies and procedures related to stock buybacks—not insider trading.

Following the announcement of the *Andeavor* settlement, then-SEC Chairman Clayton reiterated his call for issuers to implement "policies and procedures to ensure that when [buybacks] are put in place or restarted, the company does not have material nonpublic information."[20] He also noted that SEC staff were preparing a report on the growth of share repurchases and were considering this and other issues relating to 10b5-1 plans as part of that report.[21] Finally, he advised that "in addition to fostering an environment of compliance . . . around trading by senior executives and board members,

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[16] 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.

[17] *See* Jay Clayton, Chairman, SEC, Letter to Rep. Brad Sherman ("Clayton Letter") (Sept. 14, 2020), available at https://www.sec.gov/files/clayton-letter-to-chairman-sherman-20200914.pdf.

[18] Gensler Remarks (June 7, 2021).

[19] *In re Andeavor LLC*, Exchange Act Rel. No. 90208 (Oct. 15, 2020), https://www.sec.gov/litigation/admin/2020/34-90208.pdf.

[20] Paul Kiernam, *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; *see also*, Jay Clayton, Chairman, SEC, Testimony before Senate Committee on Banking, Housing and Urban Affairs (Nov. 17, 2020), https://www.banking.senate.gov/hearings/10/23/2020/oversight-of-the-securities-and-exchange-commission.

[21] Clayton Letter (Sept. 14, 2020).

boards of directors, and their compensation committees, should consider the interplay between company share repurchase plans and such [executive and board member] trading, including when approving Rule 10b5-1 plans."[22]

Likely Areas to Be Addressed by New Rules Governing Rule 10b5-1 Plans

It is against this backdrop that Gensler announced that he had asked the SEC staff to make recommendations on how to "freshen up Rule 10b5-1." During his announcement he referenced a recent academic study by the Stanford University Graduate School of Business which identified the following three red flags for Rule 10b5-1 plans: (a) plans with a short "cooling-off period" between adoption of the plan and commencement of trading; (b) plans that entail only a single trade; and (c) plans adopted in a given quarter that begin trading before that quarter's earnings announcement.[23] Gensler similarly voiced his concerns about plans with no cooling-off periods, as well as the absence of limitations on when plans may be cancelled, and the number of plans an insider may have.

Given Gensler's public declaration, it is likely that the SEC will institute meaningful changes to the rules in the near term. Although many aspects of the potential new rules may already be followed by companies and insiders, reforms will likely seek to mandate these practices in an effort to limit abuses and to provide the SEC and the public with great transparency into insider transactions. We believe it is likely that proposed modifications to Rule 10b5-1 will include some or all of the following:

1. Mandatory "Cooling-Off Period"

The Commission may address the length of time between the establishment of a Rule 10b5-1 plan and the first trade permitted under such plan. In his remarks on June 7, 2021, Gensler cited a Stanford Graduate School of Business study which found that 14% of restricted stock sales in 10b5-1 plans occur within the first month of a plan's adoption and roughly 40% occur within the first two months.[24] Gensler suggested that a cooling-off period of four to six months had "public bipartisan support" from SEC Democratic commissioners, as well as former SEC Chair Clayton.[25] A requirement that several months pass between creating a plan and trading pursuant to that plan will mitigate the risk that the insider would benefit from any material nonpublic information that may have been known to him or her at the time of the plan's formation. It would also eliminate the insider's ability to benefit in the short term from changes in an issuer's stock price. For the same reason, new rules may also seek to limit large sales immediately following plan initiation that may seek to take advantage of near-term changes to an issuer's stock price.

2. Required Disclosure

The SEC may also require issuers to publicly disclose all adoptions, modifications, terminations, and suspensions of Rule 10b5-1 plans by company insiders perhaps through Form 8-K and/or press release. This change would significantly increase upfront transparency for regulators and investors into insider transactions the current Form 4 filing regime does not provide. It may also benefit issuers by conditioning market reaction to ensuing insider transactions. The public would be able to readily ascertain whether an insider transaction which initially appears suspiciously timed to coincide with a corporate news announcement was actually made pursuant to a Rule 10b5-1 plan established long before the insider had material nonpublic information about the pending announcement.

3. Restrictions on Modifying or Cancelling a Trading Plan

The SEC may further mandate that Rule 10b5-1 plans be modified, suspended, or cancelled only during open trading windows, and/or require a cooling-off period before trading can resume. As Gensler noted, "canceling a plan may be as economically significant as carrying out an actual transaction."[26] Such change would seek to prevent an insider from

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[22] *Id*.

[23] Gensler Remarks (June 7, 2021), *citing* 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) ("Stanford GSB Study"), available at https://www.gsb.stanford.edu/sites/default/files/publication-pdf/cgri-closer-look-88-gaming-the-system.pdf.

[24] Gensler Remarks (June 7, 2021), *citing* Stanford GSB Study.

[25] Gensler Remarks (June 7, 2021), *citing* Clayton Letter; Caroline Crenshaw and Daniel Taylor, "Insider Trading Loopholes Need to Be Closed" (Mar. 15, 2021), available at https://www.bloombergquint.com/gadfly/insider-trading-loopholes-need-to-be-closed; Lee Letter.

[26] Gensler Remarks (June 7, 2021).

manipulating an existing plan based on contemporaneous material nonpublic developments that could impact the stock price. The SEC may also seek to limit any broker discretion in implementing a Rule 10b5-1 plan.

4. Limit on Number of Plans

We believe that the SEC will likely impose limits on the number of Rule 10b5-1 plans that can be adopted, both cumulatively and simultaneously. Gensler stressed the importance of limiting the number of Rule 10b5-1 plans to increase investor confidence in the markets and avoid the perception that insiders can pick and choose which plan benefits them the most at any particular time.[27] It may disallow overlapping plans altogether, and may set minimum and maximum terms that may be set in order to reduce the plan adopter's ability to manipulate a Rule 10b5-1 plan based on changes in an issuer's stock price.

Finally, Gensler did not provide specifics with respect to his statement that he also asked SEC staff to consider other potential reforms to Rule 10b5-1, including the intersection with share buybacks. However, issuers should have robust internal controls to provide assurance that they are not implementing share repurchases while in possession of material nonpublic information. They should be similarly vigilant to prohibit senior executives and directors from adopting Rule 10b5-1 sales plans while in possession of material nonpublic information concerning the issuer's stock repurchase plans.

In his announcement Gensler did not just signal likely changes to Rule 10b5-1. He emphasized that even under existing rules, if insiders do not act in good faith when using 10b5-1 plans those plans will not offer them an affirmative defense. He warned that "in addition to evaluating the rule itself, SEC staff will use all of the tools in our toolbox to ensure we are identifying and punishing abuses of 10b5-1 plans."[28] Thus, the SEC is likely to be watching for abuses of 10b5-1 plans under the existing rule even while it considers future amendments to the rule. Moreover, it is not just corporate executives who may face regulatory scrutiny. SEC staff may also scrutinize an issuer's policies and procedures governing 10b5-1 plans as an essential part of a public company's internal controls to prevent the misuse of material nonpublic information.

Issuers and corporate insiders should consider now what changes can be made proactively to bring their Rule 10b5-1 plans in line with industry best practices. Doing so as soon as possible may help avoid regulatory scrutiny and demonstrate good corporate citizenship in the event a question arises regarding insider purchases or sales of an issuer's securities.

If you have any questions regarding the topics discussed in this article, please contact **Matthew A. Rossi** at +1 (202) 312 3020, **Brooke E. Conner** at +1(312) 609 7529 or any Vedder Price attorney with whom you have worked.

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[27] *Id*.

[28] *Id.*