Clients&FriendsMemo

SEC Adopts Tougher Trading Rules for Corporate Insiders

December 28, 2022

On January 13, 2022, the Securities and Exchange Commission (the "***SEC***") proposed several rule and form amendments to address potentially abusive practices relating to the use of Rule 10b5-1 plans, grants of options and other similar equity instruments, and gifts of securities (the "***Proposed Rules***"). After considering numerous comment letters on the Proposed Rules, on December 14, 2022, the SEC adopted amendments to Rule 10b5-1 under the Securities Exchange Act of 1934, as amended (the "***Exchange Act***"), and new disclosure requirements intended to strengthen investor protections regarding insider trading. Unlike the Proposed Rules, the final amendments (the "***Final Rules***") do not apply to trading activities of issuers. The Final Rules impose the following additional conditions on the availability of the affirmative defense provided by Rule 10b5-1(c)(1):

- cooling-off periods applicable to directors and "officers" (as defined by Rule 16a-1(f) under the Exchange Act) and other persons except for the issuer;
- a certification condition for directors and officers;
- limitation on the ability of persons other than the issuer to use multiple overlapping Rule 10b5-1 plans;
- limitation on the ability of the Rule 10b5-1(c)(1) affirmative defense for a single-trade plan to one single-trade plan (subject to certain limited exceptions) during any consecutive 12-month period for all persons other than the issuer; and
- a condition that all persons entering into a Rule 10b5-1 plan must act in good faith with respect to that plan.

In addition, the Final Rules impose the following additional disclosure and reporting requirements:

- quarterly disclosure by registrants regarding the use of Rule 10b5-1 plans and certain other trading arrangements by registrant's directors and officers for the trading of its securities; and
- annual disclosure in new Item 408 of Regulation S-K of registrant's insider trading policies and procedures and corresponding amendments to Forms 10-Q and 10-K;

- a new mandatory Rule 10b5-1(c) checkbox on Forms 4 and 5;
- certain tabular and narrative disclosures regarding awards of options, stock appreciation rights and/or similar option-like instruments granted to corporate insiders shortly before and immediately after the release of material nonpublic information in new paragraph (x) to Item 402 of Regulation S-K;
- requirement that registrants tag the information specified by new Items 402(x), 408(a), and 408(b)(1) in Inline XBRL; and
- requirement to report *bona fide* gifts of equity securities on Form 4, rather than on Form 5.

These amendments are discussed below in more detail and are intended to improve investor confidence in the securities markets, and, at the same time, ensure liquidity and flexibility for traders who would like to plan securities transactions in advance when they are not aware of material nonpublic information.

Issuers will be required to comply with the new disclosure and tagging requirements in periodic reports on Forms 10-Q, 10-K and 20-F and in any proxy or information statements that are required to include the Item 408, Item 402(x), and/or Item 16J disclosures in the first filing that covers the first full fiscal period that begins on or after April 1, 2023, provided, that the compliance date for issuers that are "smaller reporting companies" as defined in Rule 405 under the Securities Act of 1933, as amended, and Rule 12b-2 under the Exchange Act, will be October 1, 2023. Section 16 reporting persons will be required to use amended Forms 4 and 5 for beneficial ownership reports starting April 1, 2023.

I. Amendments to Rule 10b5-1

a. Mandatory Cooling-off Period

After consideration of the comments it received, the SEC adopted a modified cooling-off period that will apply to all persons other than the issuer, with directors and officers of issuer subject to a longer cooling-off period than other persons who rely on the affirmative defense provided by Rule 10b5-1(c)(1). A cooling-off period is intended to provide a separation in time between the adoption of the plan and the start of trading under the newly-adopted plan in order to minimize the ability of an insider to benefit from material nonpublic information the insider may have.

A director or officer who adopts or modifies a Rule 10b5-1 plan will not be able to rely on affirmative defense of the plan unless the plan does not allow trading under the plan to begin before the later of (1) 90 days after the adoption of the plan or (2) two business days following the disclosure of the issuer's financial results in a Form 10-Q or Form 10-K for the fiscal quarter in which the plan was adopted or, in the case of foreign private issuers, in a Form 20-F or Form 6-K

that discloses the issuer's financial results (in each case, subject to a maximum of 120 days after adoption of the plan).

b. Mandatory Director and Officer Certifications for New and Modified Rule 10b5-1 Plans

The final Rule 10b5-1(c)(1)(ii)(C) adopted by the SEC states that, if a director or officer of the issuer of securities establishes or modifies a Rule 10b5-1 plan, the plan will not provide an affirmative defense unless the director or officer includes a representation in the plan certifying that at the time of its adoption or modification (as applicable), the director or officer is not aware of material nonpublic information about the issuer or its securities, and the director or officer is adopting the plan in good faith and not as part of a plan or scheme to evade the prohibitions of Rule 10b-5.

c. Restrictions on Overlapping and Single-Trade Plans

The Final Rules added a condition to the Rule 10b5-1(c)(1) affirmative defense that persons, other than issuers, generally may not at any time have multiple contracts, instructions or plans that would qualify for the Rule 10b5-1 affirmative defense during the same period. In adopting this amendment, the SEC noted that multiple overlapping plans can be used for impermissible hedging or may allow trading on the basis of material nonpublic information by an insider who had otherwise complied with the provisions of Rule 10b5-1. To address received comments, the SEC added several clarifications and exceptions to the single plan requirement.

The first one addresses an insider's use of multiple broker-dealers to execute trades under a single Rule 10b5-1 plan that covers securities held in different accounts by providing that a series of separate contracts with different broker-dealers or other agents acting on behalf of the insider may be treated as a single "plan" if those contracts, taken together as a whole, meet all applicable conditions of, and remain collectively subject to, the provisions of Rule 10b5-1(c)(1). In addition, a broker-dealer or other agent executing trades on behalf of the insider under a Rule 10b5-1 plan may be substituted by a different broker-dealer or other agent as long as the purchase or sale instructions under the plan do not change.

The second one permits any person (other than the issuer) to maintain two separate Rule 10b5-1 plans if trading under the second plan is authorized to begin only after all trades under the first plan have been completed or expired without execution and the cooling-off period that would be applicable under Rule 10b5-1(c)(1)(ii)(B) to the second plan if it were adopted on the date of termination of the first plan has ended.

The third one provides that an insider will not lose the benefit of the affirmative defense under an otherwise eligible Rule 10b5-1 plan if the insider puts in place another plan that would qualify for the affirmative defense, so long as the additional plan only authorizes qualified sell-to-cover

transactions where an agent is only authorized to sell securities as necessary to satisfy tax withholding obligations incident to the vesting of a compensatory award, and the insider does not exercise control over the timing of such sales. This exception, however, is not applicable to sales relating to the exercise of option awards because such exercise occurs at the discretion of the insider, and therefore, may occur when the insider is in possession of material nonpublic information.

Finally, consistent with the restrictions on multiple overlapping plans, the Final Rules provide that if a contract, instruction, or plan adopted by any person other than the issuer is designed to effect an open-market purchase or sale of securities as a single transaction, the affirmative defense will not be available if the person had, during the preceding 12-month period, adopted another single-trade plan that qualified for the affirmative defense under Rule 10b5-1. A plan is "designed to effect" the purchase or sale of securities as a single transaction if it has the practical effect of requiring that result.

d. Amendment to the Good Faith Condition

The Final Rules add a condition that a person who entered into a Rule 10b5-1 plan must act "in good faith with respect to the contract, instruction, or plan." For example, a corporate insider would not be operating a Rule 10b5-1 plan in good faith if the corporate insider, while aware of material nonpublic information, induces the issuer to publicly disclose that information in a manner that benefits insider's trades under the plan.

II. Additional Disclosures Requirements

To address concerns that the absence of mandatory disclosure requirements of Rule 10b5-1 and other trading arrangements of corporate insiders creates an environment in which it is more difficult for investors to assess whether corporate insiders may be misusing their access to material nonpublic information, the SEC included several new disclosure requirements in the Final Rules.

a. Quarterly Reporting of Trading Arrangements

The Final Rules add a new Item 408(a) of Regulation S-K that requires each registrant to disclose in Forms 10-Q and 10-K any adoption or termination by any of its directors or officers of any contract, instruction or written plan for the purchase or sale of securities of the registrant that is intended to satisfy the affirmative defense conditions of Rule 10b5-1(c) and/or any non-Rule 10b5-1 trading arrangement as defined in Item 408(c) and to provide a description of the material terms of such trading arrangements (other than certain pricing information).

b. Mandatory Disclosure of Insider Trading Policies and Procedures

A new Item 408(b) of Regulation S-K and new Item 16J in Form 20-F, added by the Final Rules, require registrants to disclose in their annual reports on Form 10-K (Item 16J in Form 20-F for

foreign private issuers) and proxy and information statements on Schedules 14A and 14C whether they have adopted insider trading policies and procedures.

c. Identification of Transactions Intended to Satisfy Rule 10b5-1(c) on Forms 4 and 5

Section 16(a) of the Exchange Act requires corporate officers, directors, and principal shareholders to disclose changes in their beneficial ownership on Form 4 or 5, which are publicly available. The Final Rule adds the mandatory Rule 10b5-1 checkboxes to Forms 4 and 5 that require the Section 16 reporting person to state that the reported transaction is intended to satisfy the affirmative defense conditions of Rule 10b5-1(c).

III. Mandatory Disclosure of Stock Options and Similar Instruments Granted Close in Time to the Disclosure of Material Nonpublic Information

To address concerns that a registrant may be aware of material nonpublic information at the time its board of directors grants stock options and certain option-like awards, the SEC added a new paragraph to Item 402 of Regulation S-K that would require registrants to discuss their policies and practices on the timing of such awards and provide a tabular disclosure of certain information relating to such instruments if, during the last completed fiscal year, such instruments were awarded to any named executive officer of the registrant within a period starting four business days before the filing of a periodic report on Form 10-Q or Form 10-K, or the filing or furnishing of a current report on Form 8-K that discloses material nonpublic information (other than a current report on Form 8-K disclosing a material new option award grant under Item 5.02(e)), and ending one business day after a triggering event.

IV. New Inline XBRL Data Requirements

Under the Final Rules, registrants are also required to tag the information specified by newly-added Items of Regulation S-K and new Item 16J(a) of Form 20-F in Inline XBRL, in accordance with Rule 405 and the EDGAR Filer Manual.

V. Requirement to Report Gifts of Equity Securities on Form 4

In the Final Rule, the SEC also adopted amendments to Rule 16a-3 that require Section 16 reporting persons to report *bona fide* gifts of equity securities on Form 4 (rather than Form 5). As a result, such gifts will have to be reported before the end of the second business day following the date of execution of the transaction (instead of within 45 days after the issuer's fiscal year end). This amendment is intended to address concerns that the delayed reporting of gifts on Form 5 may allow problematic practices involving gifts of equity securities while in possession of material

nonpublic information or backdating gifts of equity securities in order to maximize the related tax benefits.

Conclusion

Overall, the adopted amendments are focused on reducing ability of corporate insiders to misuse Rule 10b5-1 safe harbor in order to profit from material non-public information they have access to. The amendments are intended to address concerns about misuse of Rule 10b5-1 expressed by legislators, courts and many commenters who pointed out that corporate insiders trading pursuant to Rule 10b5-1 plans consistently outperform the trading of corporate insiders outside of such plans. Therefore, corporate insiders have to be prepared to comply with the new restrictions and disclosure requirements relating to their use of Rule 10b5-1 plans, while issuers of publicly-traded equity securities should be ready to address additional disclosure requirements relating to the use of such plans. At the same time, the SEC chose not to impose any new restrictions or disclosure requirements on the use of Rule 10b5-1 plans by issuers despite concerns expressed by some commenters. Therefore, issuer share repurchase transactions (including accelerated share repurchase transactions and other structured share repurchases) that are often structured as Rule 10b5-1 plans will not be affected by the adopted amendments.

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If you have any questions, please feel free to contact any of the following Cadwalader attorneys.

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