Hogan Lovells

SEC Update

January 4, 2022

This is a commercial communication from Hogan Lovells. See note below.

SEC proposes major Rule 10b5-1 amendments and disclosure requirements relating to securities transactions

On December 15, 2021 the SEC unveiled its long-awaited proposal to amend the requirements for securities trading arrangements adopted in reliance on Rule 10b5-1 under the Exchange Act. The proposed amendments would add new conditions to the availability of the rule's affirmative defense against liability under Exchange Act Rule 10b-5 for insider trading. As part of its larger project to curb unlawful insider trading, the SEC also proposes new disclosure requirements in Exchange Act filings relating to trading arrangements, securities transactions, and insider trading compliance policies.

The SEC's release (No. 33-11013) describing the proposed amendments can be viewed **here**. The comment period will be open for 45 days after the release is published in the Federal Register.

Proposed amendments at a glance

The SEC proposes new conditions to Rule 10b5-1(c)(1) to close "loopholes" under the rule that it believes have been used by some issuers, directors, and officers to trade on the basis of material nonpublic information.

Under the amended rule, a new or modified trading arrangement under Rule 10b5-1(c)(1) would be subject to a minimum cooling-off period before the first purchase or sale of securities may be executed under the arrangement. Other amendments would provide that the rule's affirmative defense is not available for multiple overlapping arrangements for open market trades in the same class of securities, or for trades under more than one single-trade arrangement during any consecutive 12-month period. A further amendment would expand the rule's good-faith condition to require a trading arrangement under Rule 10b5-1(c)(1) to be operated – as well as entered into – in good faith. To acknowledge key conditions, directors and officers entering into a Rule 10b5-1(c)(1) trading arrangement would be required to certify to the issuer that they are doing so in good faith and that they are not aware of material nonpublic information about the issuer or its securities.

Amendments to Regulation S-K and Exchange Act report forms would impose new disclosure requirements relating to Rule 10b5-1(c) trading arrangements and other trading schemes and to transactions in the issuer's securities. Issuers would be required to provide quarterly disclosure regarding the adoption, termination, and terms of Rule 10b5-1(c) trading arrangements and other trading arrangements involving the issuer and its directors and officers. In their annual reports, issuers would be obligated to disclose whether they have adopted insider trading policies and procedures (or, if they have not done so, to explain why not) and to describe those policies and procedures.

In addition, the disclosure amendments would require issuers to disclose in their annual proxy statements information about option grants and awards of similar instruments made within 14 calendar days before or after an earnings announcement or disclosure of other material nonpublic information. The amendments also would accelerate mandatory reporting of gifts of securities under Exchange Act Section 16(a) from a filing on Form 5 due after year-end to a filing on Form 4 due within two business days after the gift is made.

Companies and natural persons subject to proposed amendments

The proposed amendments would apply to all categories of domestic public companies. Foreign private issuers that file annual reports on Form 20-F also would be obligated to comply with the amended rules, except for the quarterly disclosure requirements, since those issuers do not file quarterly reports.

Any natural person adopting a Rule 10b5-1(c)(1) trading arrangement would be required to comply with the proposed exclusion of multiple overlapping trading arrangements and single-trade arrangements, as well as the proposed amendment to the good-faith provision. Only directors and officers would be subject to the proposed cooling-off period and certification requirements. The SEC explains that it proposes limiting the latter requirements to directors and officers – rather extending them to all issuer employees – because such insiders are responsible for making and overseeing corporate decisions, have greater control over or knowledge about the timing and substance of corporate disclosures, and are more likely to be aware of material nonpublic information.

For these purposes, "officer" would be defined in accordance with Rule 16a-1(f) under the Exchange Act, which is substantially similar to the standard for designating "executive officers" under Exchange Act Rule 3b-7.

Description of proposed amendments

New conditions to Rule 10b5-1(c)(1)

Rule 10b5-1(c)(1) establishes an affirmative defense to liability under Rule 10b-5 if the purchase or sale of securities is made pursuant to a trading arrangement in the form of a binding *contract*, an *instruction* to another person to execute the trade for the instructing person's account, or a *written plan*. Rule 10b5-1(c)(2) provides a separate affirmative defense designed solely for traders that are not natural persons.

The SEC proposes new conditions to the availability of the affirmative defense under Rule 10b5-1(c)(1) to address concerns that some issuers and insiders have abused the rule to "opportunistically trade securities on the basis of material nonpublic information in ways that harm investors and undermine the integrity of the securities markets." The SEC states that the conditions are intended to work "in tandem" to reduce such unlawful insider trading in reliance on the rule.

Mandatory cooling-off period. Rule 10b5-1(c)(1) does not currently impose a minimum waiting period after adoption of a trading arrangement before the first purchase or sale of securities may be executed, although many arrangements incorporate such "cooling-off" periods of varying durations.

The SEC proposes to require a minimum 120-day cooling-off period before the first transaction under *director and officer* trading arrangements and a minimum 30-day cooling-off period before the first transaction under *issuer* trading arrangements as a condition of the availability of the rule's affirmative defense. The SEC expects that any material nonpublic information of which the trader might be aware when entering into a trading arrangement – contrary to a key condition of Rule 10b5-1(c)(1) – likely will become stale during the cooling-off period and thereby preclude the trader from profiting from the informational advantage when the first transaction occurs.

The mandatory cooling-off period would begin after the date on which the Rule 10b5-1(c)(1) trading arrangement is adopted, which would include the adoption date for a "modified" as well as a new arrangement. Accordingly, if an existing trading arrangement is modified, a new cooling-off period would begin after the modification date. The amended rule would clarify that a "modification" of an existing arrangement would include the cancellation of one or more trades, which would be deemed to terminate the arrangement in its entirety and begin a new cooling-off period. The SEC believes that the restart of the cooling-off period in these circumstances should discourage participants from selectively canceling a planned trade.

The 120-day cooling-off period for director and officer trading arrangements would exceed the duration of a fiscal quarter. The SEC explains that it has fixed this period to minimize the chances that any trades would occur under a trading arrangement adopted during a particular quarter until the issuer discloses its financial results for the quarter. In the SEC's view, this cooling-off period "would deter insiders from seeking to capitalize on unreleased material nonpublic information" for the quarter in which they adopt a trading arrangement.

Issuers sometimes structure the operation of their share repurchase programs as Rule 10b5-1(c)(1) trading arrangements. The application of a mandatory 30-day cooling-off period could affect the timing of trading plan adoptions by such issuers, particularly those that use multiple sequential short-term plans to span trading blackout periods.

Exclusion of multiple overlapping trading arrangements. The SEC proposes to eliminate Rule 10b5-1(c)(1)'s affirmative defense for any issuer, director, or officer that establishes multiple overlapping trading arrangements for open market purchases or sales of the same class of securities.

The SEC indicates that it has proposed this restriction to preclude the use by insiders of multiple overlapping trading arrangements to selectively cancel individual trades on the basis of material nonpublic information, or to commence trades soon after the adoption of a new trading arrangement or the modification of an existing trading arrangement. Under the proposed amendment, the rule's affirmative defense would not be available for trades under a trading arrangement when the trader maintains another trading arrangement, or subsequently enters into a new trading arrangement, for open market purchases or sales of the same class of securities.

The proposed exclusion of multiple overlapping trading arrangements would not apply to trades in different classes of securities. The SEC elaborates that, as a result, a trading arrangement for open market transactions in Class A common stock and an overlapping trading arrangement for Class B common stock or for preferred stock would not be subject to the exclusion.

The exclusion also would not apply to transactions in which directors, officers, or employees acquire or sell securities for themselves directly from the issuer, such as through their participation in employee stock ownership plans or dividend reinvestment plans (to the extent such plans are effected through Rule 10b5-1(c)(1) trading arrangements), since such transactions are not executed by these participants in the open market.

Limitation of single-trade arrangements. In its release the SEC cites studies concluding that transactions under Rule 10b5-1(c)(1) trading arrangements that cover a single trade are "consistently loss avoiding" for the traders and often precede declines in the issuer's stock price, which suggests to the SEC that the traders are executing "one-off," ad hoc trades based on material nonpublic information.

To address this abuse, the SEC proposes to limit Rule 10b5-1(c)(1)'s affirmative defense to a transaction under only one single-trade plan during any consecutive 12-month period. Under the proposed amendment, the defense would not be available for a single-plan trade if, during the prior 12-month period, the trader had executed a trading arrangement that effected the purchase or sale of the total amount of securities in a single transaction.

Expansion of good-faith requirement. The Rule 10b5-1(c)(1) affirmative defense is available only if a trading arrangement was "entered into in good faith and not as part of a plan or scheme to evade" the rule's prohibitions. The SEC proposes to add a condition that the trading arrangement also be "operated" in good faith throughout the duration of the arrangement.

The current requirement to enter into a trading arrangement in good faith has been used to evaluate practices such as the cancellation or modification of trading arrangements that may indicate a lack of good faith in certain circumstances. Although the SEC identifies those particular practices as potentially violative of the augmented good-faith standard, it highlights the application of the proposed new condition to the timing of disclosures by the issuer during the term of the trading arrangement. The SEC cautions that, under the new requirement to operate a trading agreement in good faith, the rule's affirmative defense would not be available to insiders who use "their influence to affect the timing of a corporate disclosure to occur before or after a planned trade under a trading arrangement to make such trade more profitable or to avoid or reduce a loss."

Director and officer certifications. The SEC proposes to require directors and officers to certify to the issuer in writing at the time of the adoption of a new or modified Rule 10b5-1(c)(1) trading arrangement, as a condition to the availability of the rule's affirmative defense, that they:

- are not aware of material nonpublic information about the issuer or its securities, and
- are adopting the contract, instruction, or written plan in good faith and not as part of a plan or scheme to evade the prohibitions of Exchange Act Section 10(b) and Rule 10b-5.

The SEC confirms that the personal certification would not be required if the director or officer terminates an existing trading arrangement and does not enter into a new or modified trading arrangement.

The SEC intends the certification requirement to "reinforce" the "cognizance" of the certifying directors and officers of the good-faith requirement under Rule 10b5-1(c)(1) and of their obligation not to adopt a trading arrangement while aware of material nonpublic information. The SEC emphasizes that although a director or officer may consult legal counsel on the meaning of the terms "material" and "nonpublic information," the completion of the related certification would require a "fact-specific analysis" and should represent the trader's "personal determination" that the trader is not aware of material nonpublic information.

The certifying trader would be required to retain a copy of the certification for ten years, which the SEC observes is the period that coincides with the statutes of limitations that govern the SEC's ability to seek certain remedies for insider trading claims. The SEC clarifies that the proposed amendment would not require the trader to file a copy of the certification with the SEC, and that the certification would not constitute an independent basis of director or officer liability under Exchange Act Section 10(b) and Rule 10b-5.

New disclosure requirements

The SEC's rulemaking is directed at curbing unlawful insider trading conducted outside of, as well as pursuant to, Rule 10b5-1 trading arrangements. In addition to adding new conditions to Rule 10b5-1(c)(1), the proposed amendments aim to curb such insider trading by requiring issuers and insiders to provide investors with an array of new disclosures about trading arrangements, securities transactions, and compliance policies. The SEC expects that the disclosures would enable investors to assess whether those parties may have incentives to engage, or may be engaging, in trading and other securities transactions on the basis of material nonpublic information, and thereby would help to deter fraudulent conduct in violation of Exchange Act Section 10(b) and Rule 10b-5.

Quarterly reporting of Rule 10b5-1(c) and non-Rule 10b5-1(c) trading arrangements. The SEC proposes to adopt a new Item 408 of Regulation S-K, which would be the source of the new disclosure requirements in periodic reports. Issuers would be required to tag information specified by Item 408 in Inline XBRL.

Proposed Item 408(a) and related form amendments would require issuers to disclose the following information in each quarterly report on Form 10-Q and, for the fourth fiscal quarter, annual report on Form 10-K:

- whether during the last fiscal quarter *the issuer* has adopted or terminated any contract, instruction, or written plan to purchase securities of the issuer, whether or not in reliance on Rule 10b5-1(c), and the material terms of any such arrangement, including the date of adoption or termination, duration, and the aggregate amount of securities to be sold or purchased pursuant to the arrangement; and
- whether during the last fiscal quarter any *director or officer* has adopted or terminated any such trading arrangement, the name and title of each affected director and officer, and the material terms of any such arrangement, consistent with the material terms to be disclosed regarding any issuer trading arrangement.

The proposed amendment states that any modification or amendment of a prior contract, instruction, or written plan would be deemed to constitute the termination of that prior trading arrangement and the adoption of a new trading arrangement.

The SEC believes that these disclosures would enable investors to assess whether and, if so, how issuers monitor trading by their insiders and how the trading arrangements are being used. As an example, the SEC observes that if a report describes the termination of a trading arrangement, the disclosure could provide investors and the SEC "with important information about the potential misuse of inside information if the termination coincides with the release of material nonpublic information by the issuer."

Annual disclosure of insider trading policies and procedures. Under new Item 408(b) of Regulation S-K, issuers would be required to disclose annually whether they have adopted insider trading policies and procedures that are reasonably designed to promote compliance with insider trading laws, rules, and regulations, and any applicable listing standards, and, if they have adopted such policies and procedures, to describe them. The SEC emphasizes that, in describing their insider trading policies and procedures, issuers should "endeavor to provide detailed and meaningful information" from which investors can assess their sufficiency to prevent unlawful trading on the basis of material nonpublic information and how the issuer enforces compliance with the relevant requirements.

Any issuer that has not adopted insider policies and procedures would be required to disclose why it has not done so.

Domestic issuers would be required to include this disclosure in their annual reports on Form 10-K and proxy and information statements on Schedules 14A and 14C, while foreign private issuers would be obligated to provide analogous disclosure in their annual reports on Form 20-F under a new Item 16J of that form.

Identification of Rule 10b5-1(c) and non-Rule 10b5-1(c) transactions on Forms 4 and 5. The SEC proposes amending Forms 4 and 5 filed pursuant to Exchange Act Section 16(a) to add as a mandatory disclosure requirement a "checkbox" in which the filer would indicate whether a sale or purchase reported on the form was made pursuant to a Rule 10b5-1(c) trading arrangement and would provide the date of adoption of the trading arrangement. The filer would have the option to furnish additional information about the transaction. The SEC states that it was persuaded to include the new requirement in response to comments on an earlier proposal to amend Forms 4 and 5 that mandatory disclosure of this type would help investors determine whether Rule 10b5-1(c) trading arrangements "are being used to engage in opportunistic trading on the basis of insider information."

The SEC also proposes to add a second, optional checkbox in which the filer could disclose whether the transaction reported on the form was made pursuant to a trading arrangement that was not conducted in reliance on Rule 10b5-1(c).

Disclosure regarding option grants and similar instruments. The SEC proposes to amend its existing executive compensation rules to add disclosure regarding option grants and certain other equity awards under a new paragraph (x) of Item 402 of Regulation S-K.

The new requirement responds to a concern that the current rules do not provide investors with adequate information "regarding an issuer's policies and practices on stock option awards timed to precede or follow the release of material nonpublic information." The new disclosure requirements also would apply to grants of stock appreciation rights and other "similar instruments," which the SEC refers to in its release as instruments that have "option-like" features.

To identify if it has granted any timed options, an issuer would be required to include in its annual executive compensation disclosure a new table on option awards to named executive officers or directors that were granted within 14 calendar days before, or 14 calendar days after, the filing of a periodic report, an issuer share repurchase, or the filing or furnishing of a current report on Form 8-K that discloses material nonpublic information, including earnings information. The table would be required to present, with respect to each such option award, information regarding the number of securities underlying the award, the date of grant, the grant date fair value, and the option exercise price. The table also would show the market value of the underlying securities on the trading day before the disclosure of material nonpublic information (if the awards were made within 14 calendar days before such disclosure) or on the trading day after the disclosure of material nonpublic information (if the awards were made within 14 calendar days after such disclosure).

The new table, together with enhanced narrative disclosure, is intended to provide shareholders with "a full and complete picture of any spring-loaded or bullet-dodging option grants during the fiscal year." The new item also would require the issuer to describe – in its Compensation Discussion and Analysis if it is subject to CD&A requirements – its option grant policies and practices regarding the timing of option grants and the release of material nonpublic information. The disclosure would be required to specify how the board of directors determines when to grant options and whether, and if so, how, the board or compensation committee takes material nonpublic information into account when determining the timing and terms of an award.

Issuers would be required to present the new disclosure in annual reports on Form 10-K (which may be incorporated by reference to disclosure in the annual proxy statement) and in proxy and information statements relating to director elections, shareholder approval of new compensation plans, and advisory (say-on-pay) votes to approve executive compensation. Issuers would be required to tag the information specified by Item 402(x) in Inline XBRL.

Reporting of gifts on Form 4. Current reporting requirements under Exchange Act Rule 16a-3 permit a filer to report any bona fide gift of equity securities on Form 5, which must be filed within 45 days after the issuer's fiscal year in which the gift was made. The SEC states that the deferred reporting "may allow insiders to engage in problematic practices involving gifts of securities," including "opportunistically timing gifts of securities while aware of material nonpublic information relating to such securities." To address this concern, the SEC proposes to require any Section 16 filer making a gift of the issuer's securities to report the gift on Form 4 before the end of the second business day following the date of execution of the transaction.

Looking ahead

If adopted in the form proposed, the rule amendments would require sensitive disclosures and expose the operation of important compliance policies and procedures, as well as related corporate governance practices, to regulatory and investor scrutiny. Issuers and their directors and officers would be well served to consider early the implications of the potential changes, since the proposal's abbreviated 45-day comment period suggests that the SEC may move quickly to adopt the new requirements.

The SEC acknowledges that the proposed changes to Rule 10b5-1(c)(1), which would narrow the conditions under which the rule's affirmative defense would be available, could reduce the rule's appeal to some issuers and insiders. As the SEC also notes, however, traders choosing not to rely on Rule 10b5-1(c) in purchasing or selling securities may incur other costs. These could include their inability to have transactions executed during trading blackout periods, additional costs to determine whether proposed trades may be conducted in compliance with the federal securities laws and SEC rules, and a potential increase in legal liability risk.

The SEC intends its disclosure reforms to incentivize issuers and insiders to take measures to eschew securities transactions that could be seen as allowing them to profit from material nonpublic information. The operation of this incentive is evident in the proposed amendment that would require issuers to disclose whether they have adopted insider trading policies and procedures prohibiting such transactions, which can be expected to motivate some issuers that have not adopted such policies and procedures to do so. This regulatory technique has shaped other elements of the SEC's proposed disclosure package, which could elicit disclosures about the timing and substance of securities transactions that may draw negative attention from investors and the SEC. Accordingly, any preparation for compliance with the new disclosure requirements should be undertaken together with a wide-ranging review of the adequacy of corporate policies and practices that are designed to promote lawful trading activity.

This SEC Update is a summary for guidance only and should not be relied on as legal advice in relation to a particular transaction or situation. If you have any questions or would like any additional information regarding this matter, please contact your relationship partner at Hogan Lovells or any of the lawyers listed in this update.

Contributors

Alan L. Dye (co-editor)
Partner, Washington, D.C.
T +1 202 637 5737
alan.dye@hoganlovells.com

Richard Parrino (co-editor)
Partner, Washington, D.C.
T +1 202 637 5530
richard.parrino@hoganlovells.com

C. Alex Bahn
Partner, Washington, D.C., Philadelphia
T +1 202 637 6832 (Washington, D.C.)
T +1 267 675 4619 (Philadelphia)
alex.bahn@hoganlovells.com

John B. Beckman
Partner, Washington, D.C.
T +1 202 637 5464
john.beckman@hoganlovells.com

Kevin K. Greenslade
Partner, Northern Virginia
T +1 703 610 6189
kevin.greenslade@hoganlovells.com

Tiffany Posil
Partner, Washington, D.C.
T +1 202 637 3663
tiffany.posil@hoganlovells.com

Abigail C. Smith
Partner, Washington, D.C.
T +1 202 637 4880
abigail.smith@hoganlovells.com

Additional contacts

Steven J. Abrams
Partner, Philadelphia
T +1 267 675 4671
steve.abrams@hoganlovells.com

Richard B. Aftanas
Partner, New York
T +1 212 918 3267
richard.aftanas@hoganlovells.com

Jessica A. Bisignano
Partner, Philadelphia
T +1 267 675 4643
jessica.bisignano@hoganlovells.com

David W. Bonser
Partner, Washington, D.C.
T +1 202 637 5868
david.bonser@hoganlovells.com

Glenn C. Campbell
Partner, Baltimore, Washington, D.C.
T +1 410 659 2709 (Baltimore)
T +1 202 637 5622 (Washington, D.C.)
glenn.campbell@hoganlovells.com

David Crandall
Partner, Denver
T +1 303 454 2449
david.crandall@hoganlovells.com

John P. Duke
Partner, Philadelphia, New York
T +1 267 675 4616 (Philadelphia)
T +1 212 918 5616 (New York)
john.duke@hoganlovells.com

Allen Hicks
Partner, Washington, D.C.
T +1 202 637 6420
allen.hicks@hoganlovells.com

Paul Hilton
Partner, Denver, New York
T +1 303 454 2414 (Denver)
T +1 212 918 3514 (New York)
paul.hilton@hoganlovells.com

Eve N. Howard
Partner, Washington, D.C.
T +1 202 637 5627
eve.howard@hoganlovells.com

William I. Intner
Partner, Baltimore
T +1 410 659 2778
william.intner@hoganlovells.com

Bob Juelke
Partner, Philadelphia
T +1 267 675 4615
bob.juelke@hoganlovells.com

Paul D. Manca
Partner, Washington, D.C.
T +1 202 637 5821
paul.manca@hoganlovells.com

Michael E. McTiernan
Partner, Philadelphia
T +1 202 637 5684
michael.mctiernan@hoganlovells.com

Brian C. O'Fahey
Partner, Washington, D.C.
T +1 202 637 6541
brian.ofahey@hoganlovells.com

Leslie (Les) B. Reese, III
Partner, Washington, D.C.
T +1 202 637 5542
leslie.reese@hoganlovells.com

Richard Schaberg
Partner, Washington, D.C., New York
T +1 202 637 5671 (Washington, D.C.)
T +1 212 918 3000 (New York)
richard.schaberg@hoganlovells.com

Michael J. Silver
Partner, New York, Baltimore
T +1 212 918 8235 (New York)
T +1 410 659 2741 (Baltimore)
michael.silver@hoganlovells.com

Andrew S. Zahn
Partner, Washington, D.C.
T +1 202 637 3658
andrew.zahn@hoganlovells.com

Tifarah Roberts Allen
Counsel, Washington, D.C.
T +1 202 637 5427
tifarah.allen@hoganlovells.com

Stephen M. Nicolai
Counsel, Philadelphia
T +1 267 675 4642
stephen.nicolai@hoganlovells.com

Alicante
Amsterdam
Baltimore
Beijing
Birmingham
Boston
Brussels
Budapest*
Colorado Springs
Denver
Dubai
Dusseldorf
Frankfurt
Hamburg
Hanoi
Ho Chi Minh City
Hong Kong
Houston
Jakarta *
Johannesburg
London
Los Angeles
Louisville
Luxembourg
Madrid
Mexico City
Miami
Milan
Minneapolis
Monterrey
Moscow
Munich
New York
Northern Virginia
Paris
Perth
Philadelphia
Riyadh*
Rome
San Francisco
São Paulo
Shanghai
Shanghai FTZ*
Silicon Valley
Singapore
Sydney
Tokyo
Ulaanbaatar*
Warsaw
Washington, D.C.

*Our associated offices
Legal Services Centre: Berlin

www.hoganlovells.com