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SEC Looks to Amend Rules On Issuer and Insider Securities Transactions

In a populist era, few things can be counted upon to attract more attention from politicians and the media than transactions in the securities of public companies by those companies and their insiders. While those who work with companies and insiders may well conclude that the discussion of these topics has generated a lot more heat than light, it has long been a foregone conclusion that the SEC would act to "reform" the rules governing insider transactions, whether those rules needed reforming or not.

In December 2021, the SEC issued a rule proposal intended to address potential abuses of Rule 10b5-1, which provides an affirmative defense to insider trading claims for transactions executed pursuant to a pre-existing trading plan adopted at a time when the company or an insider was not in possession of material nonpublic information. Release No. 33-11013, *Rule 10b5-1 and Insider* Trading, (Dec. 15, 2021). On the same day, the SEC also issued a rule proposal that would impose new disclosure obligations on companies engaging in repurchases of their securities, whether pursuant to 10b5-1 plans or otherwise. Release No. 34-93783, *Share Repurchase Disclosure Modernization,* (Dec. 15, 2021).

Both of these proposals would involve significant changes to the obligations imposed on insiders and public companies when engaging in transactions in their company's securities. What follows is an overview of the proposals and some of their potential implications.

Background on Rule 10b5-1

The SEC adopted Rule 10b5-1 under the Exchange Act in August 2000. The rule was adopted to clarify inconsistent judicial interpretations of what constituted trading "on the basis of" material non-public information. Under Rule 10b5-1, a person is regarded as trading on the basis of material nonpublic information if they are aware of the information when making the trade. In other words, mere possession of material nonpublic information is sufficient to establish insider trading liability.

Rule 10b5-1 also provides an affirmative defense to insider trading liability for transactions satisfying conditions laid out in paragraph (c) of the rule. Specifically, in order to be able to raise the affirmative defense, the person must have entered into a binding contract to purchase or sell the security, instructed another person to purchase or sell the security on its behalf, or adopted a written plan for trading securities prior to the time the person became aware of the material nonpublic information. These arrangements are referred to as "Rule 10b5-1 plans."

A Rule 10b5-1 plan must specify the amount of securities involved in the transaction, as well as the price at which and the date on which the securities are to be purchased or sold. This information could either be spelled out in the plan itself or the plan could lay out a formula, algorithm, or computer program for determining the amounts, prices, and dates.

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Alternatively, transactions under a plan could qualify for the affirmative defense if they did not permit the insider to exercise any subsequent influence over the transactions, and also prohibited anyone who did exercise such influence from doing so while aware of material nonpublic information.

The rule also requires a trading plan to be entered into "in good faith and not as part of a plan or scheme to evade the prohibitions of this section."

In its recent proposing release, the SEC noted that concerns have been raised about a number of practices involving Rule 10b5-1 plans. According to the release, "these include using multiple overlapping plans to selectively cancel individual trades on the basis of material nonpublic information, or commencing trades soon after the adoption of a new plan or the modification of an existing plan." In addition, the SEC noted concerns that companies were abusing Rule 10b5-1 plans to engage in buybacks timed to boost the stock price before sales by corporate insiders.

The proposing release also noted that since Rule 10b5-1's adoption, courts and other constituencies have contended that the affirmative defense has allowed traders to abuse the rule's liability protections by opportunistically trading securities on the basis of material nonpublic information. The SEC cited academic studies indicating that insiders who use Rule 10b5-1 plans consistently outperform those who do not.

The SEC's rule proposals were prompted by its belief that these potential issues surrounding Rule 10b5-1 plans and the other matters it addressed in the proposing release "undermine the public's confidence and expectations of honest and fair capital markets by creating the appearance that some insiders, by virtue of their positions, do not play by the same rules as everyone else."

The SEC's Proposed Amendments

The SEC's proposed amendments to Rule 10b5-1 had their genesis in recommendations provided last summer by the SEC's Investor Advisory Committee, and generally track those recommendations. However, a few IAC recommendations did not make the cut — the most notable of these was a recommendation that the SEC require that companies file a Form 8-K to report the adoption, modification, or cancellation of Rule 10b5-1 plans.

The SEC's proposal also includes some features that were not included in the IAC's list of recommendations, including changes to the timing of Section 16(a) reporting of gifts of securities and disclosure of equity awards made prior to the release of material nonpublic information. The SEC's rule proposals on these topics were prompted by concerns about "spring loaded" option grants and by research indicating that some insiders were "opportunistically timing gifts of securities while aware of material non-public information."

The Rule 10b5-1 proposal represents one of the rare actions in recent years that received the support of all commissioners. The SEC's release includes proposed amendments to rules and forms to address "potentially abusive" practices associated with Rule 10b5-1 plans, equity awards and gifts The proposed changes would:

- Impose a 120-day mandatory cooling-off period before any trading can begin after the adoption or modification of a Rule 10b5-1 plan by officers or directors, and a 30-day mandatory cooling-off period before any trading can commence after the adoption or modification of such a plan by an issuer.
- Exclude multiple overlapping trading plans involving the same class of securities from the affirmative defense provided under Rule 10b5-1(c)(1) and limit the availability of the defense for a single-trade plan to one such plan during any consecutive 12-month period.
- Impose a certification requirement, under which officers and directors adopting a Rule 10b5-1 plan would be obligated to certify that they are not aware of material nonpublic information about the issuer or the security when they adopt it.
- Amend the existing condition that a Rule 10b5-1 trading arrangement be *entered*

into in good faith to further require that the trading arrangement also be *operated* in good faith.

- Add new disclosure requirements, including the addition of new quarterly disclosures addressing the adoption and termination of Rule 10b5-1 plans and "other trading arrangements" by directors, officers and issuers and the terms of those arrangements, and mandate that these disclosures be reported using Inline XBRL.
- Mandate Form 10-K or Form 20-F disclosure concerning whether or not (and if not, why not) the issuer has adopted insider trading policies and procedures governing securities transactions by insiders and employees that are reasonably designed to promote compliance with insider trading laws and regulations. If the issuer has such policies and procedures, it will be required to disclose them, and that disclosure would be subject to the officer certification requirements under Section 302 of Sarbanes-Oxley. These disclosures will also be required to be tagged using Inline XBRL.
- Require the disclosure of equity compensation awards, such as stock options and SARs, close in time to the issuer's disclosure of material nonpublic information through earnings releases or other announcements and require that disclosure to be reported using Inline XBRL.
- Eliminate the ability of insiders to report gifts of securities on a deferred basis using Form 5 and mandate disclosure on Form 4 within two business days after such a gift is made.

The SEC's proposals fall into two general categories: new conditions to the availability of the Rule 10b5-1(c)(1) affirmative defense, and new disclosure and reporting requirements for insider transactions.

New Conditions for the Affirmative Defense. It will be interesting to see what commenters have to say about the proposed prohibition on multiple overlapping plans and the limitation of single trade plans to only one in any 12-month period. A starting point might be getting the SEC to provide a definition of exactly what it means by "multiple overlapping plans."

The proposed requirement that a Rule 10b5-1 plan be "operated" in good faith seems to be more of a clarification of the SEC's existing position that actions taken subsequent to a plan's adoption may call into question whether it was entered into in good faith, while the proposed certification requirement seems to be a pointless bureaucratic exercise.

Whatever their merits, these proposed conditions are likely to be less consequential than the imposition of mandatory cooling-off periods for insiders and issuers. Cooling-off periods for officers and directors are a fairly standard practice under Rule 10b5-1 plans, but few have imposed ones as lengthy as the SEC proposes to require.

One can certainly understand why a cooling-off period for a Rule 10b5-1 plan might be a best practice to help avoid the appearance of impropriety, but legally, a cooling-off period is irrelevant under the terms of the existing rule. In order for the affirmative defense to apply, an insider must adopt a Rule 10b5-1 plan at a time when the insider is not in possession of material nonpublic information. If the insider does have material nonpublic information when the plan is adopted, no cooling-off period — however lengthy — will allow that person to claim the benefit of the affirmative defense.

The call for the imposition of cooling-off periods and other new conditions to the availability of the safe harbor has been prompted in large part by political pressure and studies showing that insiders who trade under Rule 10b5-1 plans do better than those who do not. The premise is that these improved trading outcomes are sufficiently indicative of abuse to warrant a regulatory fix. That premise is warmly embraced by politicians and the academics whose studies feature so prominently in the proposing release, but there are at least some reasons to question its validity.

For example, in the proposing release, the SEC states the following: "some academic studies of Rule 10b5-1 trading arrangements have shown that corporate insiders trading pursuant to Rule 10b5-1 consistently outperform trading of executives and directors not conducted under a Rule 10b5-1 trading arrangement." That criticism

does not seem to differ much from simply saying that those who engage in long-range personal financial planning tend to do better than those who do not. Is that really indicative of a problem?

It also seems fair to suggest that critics have overlooked the fact that the potential for outperformance by insiders with Rule 10b5-1 plans is part of the rule's DNA. After all, the rule expressly permits trades during periods in which insiders who do not implement a plan would be prohibited from trading, thereby permitting insiders with plans in place to enjoy gains or avoid losses that other insiders may not. In other words, outperformance is not a bug — it's a feature. Indeed, it is precisely what Rule 10b5-1 is intended to permit.

There are more sophisticated critiques of Rule 10b5-1, including those that focus on the difference in performance based on the length of the cooling-off periods, but neither the SEC nor any of the proponents of Rule 10b5-1 reform have addressed the glaring absence of enforcement proceedings targeting Rule 10b5-1 plan abuses. In fact, when Commissioner Lee was called upon by a group of senators last year to tell them how many enforcement actions the SEC has taken with regard to these plans over the past five years, she was unable to identify a single example. Instead, the best she could come up with was a list of six actions in which "public charging documents mention Rule 10b5-1 plans."

Commissioner Lee's inability to cite any enforcement proceedings targeting alleged abuses by Rule 10b5-1 plans suggest that either the SEC has been asleep at the switch for quite some time or that the rule generally works as intended. One of the reasons to think that the rule might be working fairly well is the significant compliance efforts undertaken by public companies to police the adoption of these plans. Critics of Rule 10b5-1 plans do not appear to have given any consideration to the effect that these compliance programs may have on mitigating the potential abuses that they have identified.

Almost all insider trading policies require these plans to be adopted only during open window periods, and impose requirements that insiders have the company's legal department pre-clear their adoption of a plan. In our experience, those with oversight responsibility for reviewing insider transactions and their compliance with corporate policy take their jobs seriously. Their efforts may be a significant reason why there have not been enforcement actions targeting alleged abuses in Rule 10b5-1 plans.

In any event, the presence of meaningful compliance efforts and the absence of enforcement activity provides a reason to question the extent to which Rule 10b5-1 plans present real-world risks of abuse requiring the imposition of new conditions to their use. Why should the efficacy of those compliance programs not be considered when contemplating new rulemaking?

While this same question applies to other proposed conditions to the availability of the affirmative defense, the imposition of mandatory cooling-off periods is the most significant proposed change. In a recent webcast on TheCorporateCounsel.net, our panel expressed concern that the imposition of the 120-day and 30-day cooling-off periods might result in decisions by insiders and registrants to simply not use Rule 10b5-1 plans.

As the panelists pointed out, public companies already have established quarterly trading windows in which their insiders are permitted to trade. Since that is the case, why would an insider go to the trouble of putting a plan in place that cannot be used for 120 days following its adoption? In the case of registrants, a decision to buy back shares is based on current market conditions, and most want to immediately begin purchases under a Rule 10b5-1 plan. If a 30-day cooling-off period is imposed upon them, most may simply decide not to use Rule 10b5-1.

While critics of Rule 10b5-1 plans may not have a problem with that outcome, many public companies and their advisors would view it as unfortunate. Rule 10b5-1 plans are generally viewed positively from a governance perspective. By providing a mechanism to avoid the uncertainties inherent in approving traditional insider transactions, these plans are regarded as a useful tool in preventing insider trading issues from arising. In fact, some public companies even require insiders to engage in transactions *only* through these plans.

In considering the advisability of these mandatory cooling-off periods, the SEC should consider the benefits of Rule 10b5-1, and the possibility that the implementation of lengthy mandatory cooling-off periods may well reform the rule into oblivion.

New Disclosure Requirements. The SEC's new disclosure proposals would fill a void in terms of line-item disclosure requirements addressing the adoption and termination of Rule 10b5-1 plans and would enhance disclosure concerning option awards made around the time of announcements of material nonpublic information. But more consequential are the disclosure obligations that would be imposed around public companies' insider trading policies and procedures.

The new Form 10-K disclosure requirements are extensive, and as the panelists in TheCorporateCounsel.net's webcast observed, may lead to a tightening of preclearance policies and greater attention to the design and implementation of insider trading plans. For example, one of the areas that companies would be required to address is whether there are policies governing trading by insiders during company repurchases. Since disclosure to the effect that no such policies exist is likely to be unpalatable, this is an area where many companies may impose additional restrictions on insider transactions in these situations in order to avoid potential "shaming" disclosure.

While these proposed disclosure requirements are extensive, they will put greater focus on companies' efforts to police insider trading through their compliance policies and procedures. As noted in the discussion of the proposed new conditions to the availability of the Rule 10b5-1(c)(1) affirmative defense, that is something to which critics of existing practices under the rule appear to have devoted little attention. Over time, that disclosure may help the SEC formulate more informed policy decisions concerning the regulation of Rule 10b5-1 plans.

Before closing our discussion of the proposed disclosure changes, we think a brief word of caution is appropriate concerning the changes that the SEC is proposing when it comes to accelerated Section 16 reporting of gifts of securities. While gifts have not traditionally been an area of focus for the SEC's enforcement efforts, the proposing release makes it clear that the SEC has been impressed with studies suggesting that insiders have been opportunistically using material nonpublic information to maximize the benefits of their gifts.

The proposing release indicates that the SEC believes that gifts could be regarded as "sales" for purposes of the Exchange Act under certain circumstances, which puts them squarely in the crosshairs of Rule 10b-5. Regardless of whether the proposed rule change is adopted, the language of the release suggests that the SEC's Division of Enforcement may take a greater interest in potential abuses surrounding gifting of securities.

Background on Issuer Repurchases

Issuer repurchases of outstanding shares are one of several ways to return capital to a company's shareholders. They are often viewed as being preferable to the payment of dividends because they give investors a choice as to whether or not to participate. There is also frequently an element of "financial engineering" involved in a repurchase decision, because by reducing the number of outstanding shares, companies are able to post more favorable financial metrics.

Buybacks can take many forms, including privately negotiated purchases, accelerated share repurchases and even issuer tender offers under Exchange Act Rule 13e-4. But open-market repurchase programs conducted under Exchange Act Rule 10b-18 are the most common way in which buybacks are conducted.

Rule 10b-18 provides a safe harbor for open market purchases that satisfy its disclosure, timing, volume limitations and other conditions. Other Exchange Act rules, including Regulation M and Rule 10b5-1, may also be implicated in a company's repurchase program.

Upon adoption of an open market repurchase program, companies typically announce the program by issuing a press release and/or filing a Form 8-K to and provide notice to their stock exchange. In addition, Item 703 of Regulation S-K imposes ongoing disclosure obligations in Form 10-Q and Form 10-K filings while the repurchase program is underway.

Love buybacks or hate them, public companies have devoted enormous financial resources to

repurchasing their own stock in recent years. In fact, according to S&P Global, S&P 500 companies repurchased $234.6 billion of stock in the third quarter. Not only does that represent a 130% increase over the third quarter of 2020, and an 18% increase over from the second quarter of 2021, but it also shatters the old record for buybacks of $223 billion that was set during the fourth quarter of 2018.

Many commenters have questioned corporate decisions to use their funds in this fashion, arguing that they should instead be reinvested in the business or used to improve the compensation of rank and file employees. Popular discontent with buybacks was reflected in the CARES Act, which prohibited loan recipients from repurchasing stock until at least one year after their loan had been repaid.

The SEC's Proposal

In contrast to the unanimous support enjoyed by the Rule 10b5-1 proposal, Commissioner Peirce and former Commissioner Roisman both dissented from the SEC's buybacks proposal. Unlike that proposal, this one does not impose any limitations on the ability of companies to engage in repurchases of their own shares. Instead, the SEC proposes to ramp up the disclosures required in connection with stock repurchases. Specifically, the proposal would:

- Require companies to disclose certain information about share repurchases on a new Form SR, which would be furnished (not filed) to the SEC one business day after execution of a company's share repurchase order.
- Amend Item 703 of Regulation S-K to require additional detail regarding, among other things, the rationale for a company's repurchase program, whether it has policies in place regarding insider transactions while the company is in the market, and whether the purchases are being made pursuant to a Rule 10b5-1 plan and whether they are being made under the Rule 10b-18 safe harbor.
- Require information disclosed in Form SR and pursuant to Item 703 of Regulation S-K to be reported using Inline XBRL.

Here are some of the details on the new Form SR and the changes to Item 703.

Proposed Form SR. Under the terms of a new Exchange Act Rule 13a-21 and Form SR, companies would be required to report any repurchases of securities registered under the Exchange Act that are made by or on behalf of the company or by an affiliated purchaser. The Form SR would have to be furnished prior to the end of the first business day following execution of a repurchase, and would require tabular disclosure, on a daily basis, of:

- The class of securities repurchased;
- The number of shares repurchased, whether or not made pursuant to publicly disclosed programs;
- The average price paid per share;
- The number of shares purchased on the open market;
- The number of shares purchased in reliance on the Rule 10b-18 safe harbor; and
- The number of shares purchased pursuant to a Rule 10b5-1 plan.

The proposing release says that the SEC's objective in requiring daily reporting of repurchases on Form SR is to "enhance transparency and enable more timely investor review" of repurchases. While companies are required to provide information in quarterly and annual reports about repurchases under Item 703 of Regulation S-K, that information is often provided weeks or months after the repurchase transactions in question.

The SEC is concerned about "information asymmetries" between companies and investors when companies are in the market for their shares, and believes that the daily information about repurchases provided on Form SR will help diminish these asymmetries. Here is an excerpt from the release:

> Requiring disclosure of the number of shares purchased on the open market would provide a clearer indication of the scale of the issuer's activity in the market for each day that repurchases are made. Requiring disclosure of the number of shares purchased in reliance

> on the non-exclusive safe harbor in Rule 10b-18 and pursuant to a plan that is intended to satisfy the affirmative defense conditions of Rule 10b5-1(c) could also enable investors to better understand how an issuer has structured its repurchase activity.

The SEC believes that this detailed daily information could also provide investors with additional insight into some of the alleged shenanigans surrounding buybacks. Specifically, the proposing release notes that some commentators have contended that repurchases could be used to boost share prices in order to enhance the value of stock-based compensation or to facilitate management stock sales. The proposing release says that more timely and detailed information will help investors detect repurchases that are driven by managerial self-interest.

The SEC proposes to require companies to "furnish," rather than file, Form SR. That means companies would not be subject to liability under Section 18 of the Exchange Act for information disclosed on Form SR. Since the information would not be incorporated by reference in Securities Act registration statements, companies would also not be subject to liability under Section 11 of that statute. However, like all corporate statements, those disclosures would remain subject to potential liability under Rule 10b-5.

Some early commenters on the proposal have been skeptical about the value of daily reporting, with at least one suggesting that the resulting deluge of information required by Form SR would result in the creation of "white noise" that will overwhelm investors. Alternatives suggested by commenters include requiring disclosure at the outset of and termination of the repurchase plan and the furnishing of Form SR on a weekly or monthly basis.

Some commenters have also expressed concern about the possibility that the detailed disclosures required under Form SR may provide information that could be exploited by high-frequency traders to the detriment of the market:

> The filing of daily information referencing the previous day's trading activity (price volume) will create a trading imprint that could be used by high frequency traders to front-run future orders and manipulate the underlying security price. Armed with price and volume information (from one to two days prior), high frequency traders will be able to create algorithms that could disrupt the normal price discovery process of the marketplace.

Comments of Ed Armstrong, December 28, 2021. The panelists on TheCorporateCounsel.net's webcast also expressed concerns about the potential for "signaling" resulting from daily Form SR filings, noting that these concerns are raised not only by disclosure of information about the quantity and price of repurchases, but also the potential speculation about the reasons why a company did not purchase securities on a particular day.

Proposed Amendments to S-K Item 703. The SEC's proposal would also amend Item 703 of Regulation S-K to require additional disclosure around repurchase activities. As proposed to be amended, Item 703 would require a company to disclose:

- The rationale or objectives for its share repurchases and the process or criteria it uses to determine the amount of those repurchases;
- Any policies and procedures relating to transactions in the company's securities by its officers and directors during a repurchase program, including any restrictions on such transactions;
- Whether repurchases were made under a Rule 10b5-1 plan and, if so, when the plan was adopted or terminated;
- Whether repurchases were made in reliance on the safe harbor provided by Rule 10b-18; and
- Whether any directors or Section 16 officers purchased or sold any of the company's equity securities that are the subject of a repurchase program within 10 business days before or after announcement of an issuer purchase plan.

This last disclosure item would be satisfied by checking a box before the tabular disclosure of issuer repurchases required by Item 703.

The proposing release indicates that the rationale for these proposed amendments to Item 703 is similar to the rationale underlying the proposed Form SR disclosure requirement — addressing information asymmetries and permitting investors to assess whether repurchases are being driven by managerial self-interest.

The proposal to require disclosure of the rationale underlying a company's decision to repurchase securities has been criticized by some early commenters as raising the potential for "boilerplate" disclosure. Our webcast panelists also noted that the proposed changes to Item 703 could also influence compliance practices.

For example, the need to disclose policies relating to insider transactions during a repurchase program and the "check the box" requirement concerning whether any insiders traded around the time of the announcement of a repurchase plan may result in enhanced compliance procedures in order to avoid unpalatable disclosures. Given the suspicions about Rule 10b5-1 plans, it is ironic that, as our panelists noted, these new disclosure requirements may provide incentives for insiders to put those plans in place.

What Should Public Companies Do Now?

In a signal that the rule proposals are on a fast track, the SEC announced that both rule proposals would have a comment period that lasted only 45 days after the publication of the proposals in the Federal Register. That is shorter than the typical 60-day comment period and has already been the subject of criticism by members of Congress and commenters. Perhaps as a result of that criticism, at the time we go to press, the rule proposals have yet to be published in the Federal Register, more than a month after they were issued.

In the current environment, it is a virtual certainty that rule changes along the lines laid out in the proposals will be adopted. But it is also apparent that there has been little input from public companies and those responsible for overseeing their repurchase plans and insider trading policies in the formulation of these proposals. We think their voices need to be heard before these rules are finalized, and strongly encourage our readers to weigh in on the SEC's rule proposals during the comment period.

Public companies should review the potential disclosure requirements proposed under the new rules. As they do so, they should assess what changes to their disclosure controls may be required to comply with these requirements, as well as whether they will need to enhance their infrastructure in order to comply with a potential daily reporting requirement for repurchases.

In addition, companies need to review their own policies and procedures and assess whether changes to those policies should be adopted in light of the extensive new disclosures that may be required under the final rules. In that regard, we have some suggestions about possible changes to your insider trading policies that we will share in this issue's next article.

Is Your Insider Trading Policy Ready for Prime Time?

The SEC's recently proposed Item 408 of Regulation S-K, if adopted, will shine a spotlight on insider trading policies which have, for the most part, lived in the shadows with those public company policies that are not required to be disclosed to investors. The lack of transparency around insider trading policies is not something that has necessarily drawn a great deal of regulatory attention in the past, but now it seems the SEC believes there is some benefit to investors in describing whether a public company has an insider trading policy and, if so, what it covers and how it works. The prospect of the bright glare of this new spotlight is enough to make any company want to take a fresh look at its insider trading policy (or adopt a policy if the company does not have one, so the company would not have to explain why it has not done so).

Proposed Item 408 of Regulation S-K

The SEC has proposed new Item 408 of Regulation S-K and corresponding amendments to Forms 10-Q, Form 10-K and Schedule 14A to require: (i) quarterly disclosure of the use of Rule 10b5-1 and other trading arrangements by

an issuer, and its directors and officers for the trading of the issuer's securities; and (ii) annual disclosure of an issuer's insider trading policies and procedures. The SEC is also proposing new Item 16J to Form 20-F to require annual disclosure of a foreign private issuer's insider trading policies and procedures.

As proposed, Item 408(b) of Regulation S-K would require companies to disclose whether the issuer has adopted insider trading policies and procedures governing the purchase, sale, and other dispositions of the issuer's securities by directors, officers, and employees or the company itself that are reasonably designed to promote compliance with insider trading laws, rules, and regulations, and any listing standards applicable to the company.

If a company has not adopted such insider trading policies and procedures, the company must explain why it has not done so, and if the company has adopted insider trading policies and procedures, it must disclose such policies and procedures. Interestingly enough, the SEC chose to propose a very "principles-based" disclosure requirement that applies when a company has adopted an insider trading policy, which goes against the general perception that a majority of the Commission as it is currently constituted would seem to favor more prescriptive disclosure rules over principles-based disclosure rules.

In the proposing release, the SEC does provide some insight as to what it might expect to be disclosed about insider trading policies if Item 408 is adopted as proposed.

First, the SEC notes that when making disclosure about insider trading policies and procedures under proposed Item 408(b)(2), companies "should endeavor to provide detailed and meaningful information from which investors can assess the sufficiency of their insider trading policies and procedures." For example, the SEC believes that investors may find useful, to the extent it is included in the company's relevant policies and procedures:

- Information on the company's process for analyzing whether directors, officers, employees, or the company itself when conducting an open-market share repurchase, have material nonpublic information;
- The company's process for documenting such analyses and approving requests to purchase or sell its securities;
- How the company enforces compliance with any such policies and procedures it may have; and
- Policies and procedures that apply to other dispositions of the company's securities where material nonpublic information could be "misused" such as, for example, through gifts of such securities.

The SEC is proposing to require that companies tag the information that would be required by Item 408 in Inline XBRL.

What Would This Disclosure Look Like?

An inevitable question is whether this proposed disclosure requirement could be satisfied by posting a copy of the insider trading policy on the company's website or filing a copy of the insider trading policy on EDGAR. The proposed rule does not contemplate the option of filing or posting the company's insider trading policy. Instead, if adopted, a company would be expected to include specific disclosure in the applicable filing indicating whether the company has adopted policies and procedures governing the purchase, sale and other disposition of the company's securities by insiders and employees that are reasonably designed to promote compliance with the insider trading laws and applicable listing standards, and then disclose such policies and procedures if the company does in fact have them.

We would analogize this proposed disclosure requirement to the requirement in Item 402(b)(2)(xiii) of Regulation S-K, which calls for disclosure in the CD&A (to the extent material) regarding a company's equity or other security ownership requirements or guidelines and any company policies regarding hedging the economic risk of such ownership. Similar to the disclosures elicited by that requirement, we would envision the disclosure regarding insider trading policies and procedures to provide an overview of the policies and procedures in a level of detail that makes the disclosure "meaningful" as the SEC contemplates.

In the proposing release, the SEC acknowledges that a company's existing code of ethics may contain insider trading policies. In this case, the SEC indicates that the company could cross-reference the particular components of its code of ethics that constitute insider trading policies and procedures in response to proposed Item 408(b)(2) of Regulation S-K.

The proposed Item 408(b) disclosure would be required pursuant to "Item 10. Directors, Executive Officers and Corporate Governance" in Part III of Form 10-K and in "Item 7. Directors and executive officers" in Schedule 14A. As a result, we would expect companies to include the disclosure required by proposed Item 408(b) in the proxy statement along with the rest of the director and executive officer information, and incorporate the information by reference to the proxy statement (if filed within 120 days of the end of the fiscal year), in accordance with Note 3 to General Instruction G(3) to Form 10-K.

Is it Time to Update Your Insider Trading Policy?

One of the topics that came up during our recent webcast on TheCorporateCounsel.net is whether companies should review and update their insider trading policies now, given the proposed disclosure requirement in Item 408(b) of Regulation S-K. As the panelists discussed during the webcast, there are a number of areas that companies may want to revisit now in their insider trading policies and procedures.

The Treatment of Bona Fide Gifts. As mentioned above, the SEC indicates in the proposing release that the disclosure "could address not only policies and procedures that apply to the purchase and sale of the registrant's securities, but also other dispositions of the issuer's securities where material nonpublic information could be misused such as, for example, through gifts of such securities."

In our Model Insider Trading Program documents (see the November-December 2018 *Special Supplement to The Corporate Counsel* and the "Insider Trading Policies" practice area on TheCorporateCounsel.net), we note:

> The issue of whether a gift of securities could give rise to insider trading liability continues to be debated. Counsel should be able to conclude, however, that Section 10(b) and Rule 10b-5 apply only to a purchase or sale, and a gift is neither a purchase nor a sale. Some counsel are nevertheless concerned about circumstances where a donor knows that a charitable donee will typically sell the donated stock soon after the gift, such that the donee sale while the donor is aware of material nonpublic information could result in potential insider trading liability for the donor (and potentially the donee). Absent a change in the case law, there continues to be a low level of risk in permitting *bona fide* gifts to occur while a covered person is aware of material nonpublic information or during a blackout period.

In the SEC's proposing release, there is a distinct level of concern on the part of the Commission with bona fide gift transactions. While in the context of the discussion of proposed Item 408(b) of Regulation S-K, the Commission seemed to carefully categorize bona fide gifts as an "other disposition" apart from a purchase and sale, the portion of the proposing release addressing acceleration of Section 16 reporting for bona fide gifts specifically cites concerns about the delayed reporting of bona fide gifts "allows insiders to engage in problematic practices involving gifts of securities, such as insiders making stock gifts while in possession of material nonpublic information, or backdating a stock gift in order to maximize a donor's tax benefit." Further, footnote 55 of the proposing release points out that the Exchange Act does not require that a "sale" of securities be for value, and instead provides that the "terms 'sale' or 'sell' each include any contract to sell or otherwise dispose of." Based on this analysis the SEC specifically states that "a donor of securities violates Exchange Act Section 10(b) if the donor gifts a security of an issuer in fraudulent breach of a duty of trust and confidence when the donor was aware of material nonpublic information about the security or issuer, and knew or was reckless in not knowing that the donee would sell the securities prior to the disclosure of such information."

In our Model Insider Trading Program, we suggest two alternative approaches to bona fide gifts:

- Excluding bona fide gifts entirely from the application of the insider trading policy (because the gift does not involve a "transaction" subject to the policy); or
- Treating bona fide gifts as not transactions subject to the insider trading policy, unless the person making the gift has reason to believe that the recipient intends to sell the company's securities while the donor is aware of material nonpublic information, or the person making the gift is subject to the trading restrictions specified in the policy and the sales by the donee occur during a period when trading is restricted.

In light the SEC's concerns about bona fide gifts, we no longer recommend excluding bona fide gifts entirely from the purview of the insider trading policy. Rather, our second option, or at least subjecting bona fide gifts by insiders to the pre-clearance process, is now advisable under the circumstances.

The Approach to Monitoring Material Nonpublic Information. In the proposing release, the SEC mentions as a potential disclosure item "information on the issuer's process for analyzing whether directors, officers, employees, or the issuer itself when conducting an open-market share repurchase have material nonpublic information."

The main consideration with this example is an existential one. The Commission's example raises the question of "should the insider trading policy cover trading by the company itself?" Our Model Insider Trading Program (as with most insider trading policies that we see in practice) is focused on directors, executive officers, employees and others who, by virtue of their relationship with the company, have access to material nonpublic information, and not on the company's trading in its own securities. This approach makes sense, because, as we discussed in the November-December 2018 issue of *The Corporate Counsel* (at page 1), the purpose of an insider trading policy is to establish a compliance program that reduces the company's risk of having control person liability arising from the actions of its directors and employees. All of that said, it is true that companies sometimes look to their insider trading policy for guidance as to, *e.g.,* when it is advisable for the company itself to trade in the company's own securities.

While we do not think the Commission was suggesting that insider trading policies should be revised, *en masse*, to include specific policies and procedures around the company's trading activities, the commentary does provide food for thought on whether companies need to do more to document — whether through the insider trading policy or through some other policies and procedures — the approach for assessing whether the company is in possession of material nonpublic information and the time periods when the company can be in the market for its own securities.

The Pre-clearance Process. In the proposing release, the SEC mentions as a potential disclosure item "the issuer's process for documenting [the analyses of whether persons subject to the policy are in possession of material nonpublic] and approving requests to purchase or sell its securities." While our Model Insider Trading Program and the vast majority of insider trading policies that we see today specify who is subject to pre-clearance procedures and how those pre-clearance requests should be submitted, we typically do not see as much documentation around the analysis of whether individuals submitting pre-clearance requests are in possession of material nonpublic information.

One reason for the ambiguity here is that companies tend to take different approaches to the pre-clearance process. Some companies take a more rigid "clearinghouse" approach to assessing material nonpublic information, where those responsible for the pre-clearance process act as a sort of clearinghouse for all of the company's material nonpublic information (as often determined through comprehensive guidelines) so that they are in a position to know when to reject a request for pre-clearance because an individual subject to the policy is in a position to be in possession of such information, or it is otherwise advisable that insiders refrain from trading given the circumstances. Other companies may not have the resources available to sustain this type of clearinghouse approach, and therefore may adopt a more informal approach that relies on the representations of the individual seeking pre-clearance and consultations with colleagues within the company.

While there is no one right answer as to the best approach, it is likely that the SEC (and possibly investors) would be expecting to see the rigid clearinghouse approach rather than the more informal approach. The prospect of a potential disclosure makes it a good time to revisit exactly how the company wants to approach this topic going forward.

The Policy's Compliance Mechanisms. In the proposing release, the SEC mentions as a potential disclosure item "how the issuer enforces compliance with any such policies and procedures it may have." While our Model Insider Trading Program discusses the potential consequences of violating the insider trading policy, it does not go so far as to outline exactly *how* the Company *enforces* compliance with the specific policies and procedures. Companies may want to revisit their insider trading policies now to determine if any more specificity is warranted on this front. It may be helpful to observe the compliance methods that are contemplated in some of the company's other policies that are applicable broadly to employees to see if more can be said about how compliance with the provisions of the policy should be enforced.

Rule 10b5-1 Plan Guidelines. With all of the focus that the SEC has now put on the use of Rule 10b5-1 plans with this rulemaking, it is definitely a good time to revisit how the company oversees the use of Rule 10b5-1 plans by insiders. Our Model Insider Trading Program contemplates a separate "Guidelines for Rule 10b5-1 Plans" that is referenced in the insider trading policy and which provides specific parameters for Rule 10b5-1 plans, *e.g.,* the cooling-off period, when the insider can enter into, modify or terminate a Rule 10b5-1 plan, the minimum and maximum duration and rules around modifications. If a company does not have guidelines in place for Rule 10b5-1 plans, it would be advisable to start formulating them. For those companies that do have guidelines in place, we think it is premature to make changes to the cooling off period and other conditions until the SEC adopts the final rules.

Similar to the discussion about whether the insider trading policy (or some other trading policy) should apply to the company, it may also be appropriate now to consider whether the company should adopt parameters around the use of Rule 10b5-1 plans for transactions by the company in its own securities. The SEC's proposed amendments to Rule 10b5-1 contemplate provisions that apply to individuals and to companies (such as the cooling-off period), so it may make more sense now to consider whether specific parameters should be established for the company.

A Silver Lining?

One of the perennial challenges with updating insider trading policies is trying to benchmark a company's policies against those of other companies, because only some companies voluntarily choose to post their insider trading policies on their website. Over the years, we have often conducted surveys about practices around things such as trading restrictions, pre-clearance procedures and to whom within the organization the various aspects of the policy apply, as well as other areas of common interest, but it is usually impossible to get a picture of the entire landscape from the voluntary disclosures and survey results. As a result, if Item 408(b) of Regulation S-K were adopted, it would probably go a long way to helping companies get a handle on what their peers are doing in their insider trading policies. In this way, the disclosure could lead to more uniformity in the way that companies address the various aspects of their insider trading policies.

- JJ, DL

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