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Oh, It Doesn't Show Signs of Stopping: SEC Issues More End-of-Year Rules Regarding Rule 10b5-1 Plans, Gifts of Securities, and Stock Option Awards

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You better watch out. It won't help to cry, but feel free to pout. We're telling you why: the SEC is coming to town. Yes, the U.S. Securities and Exchange Commission has been preparing for the holidays by making its list of regulatory actions related to the directors, officers and employees of public companies, and checking it twice. On December 14, 2022, the SEC continued its shopping spree and placed the following new rules in the stockings of the naughty and nice:

- The SEC amended Rule 10b5-1 under the Securities Exchange Act of 1934 (the "Exchange Act") to address its concerns about potential trading activity abuses by corporate insiders, including adding new substantive rules that will narrow the use of Rule 10b5-1 plans and new rules requiring disclosure of these arrangements;
- The SEC amended the Section 16 reporting regime to require accelerated reporting of bona fide gifts of securities on a Form 4 (filed two days after the gift is made), instead of on a Form 5 (filed after the end of the year); and
- The SEC added new Item 402(x) of Regulation S-K, which will require yet another table and additional narrative in the compensation disclosure accompanying a public company's Form 10-K and proxy statement, regarding the timing of stock option and stock appreciation right grants.

Substantive Rules Related to Rule 10b5-1 Plans

Section 10(b) and Rule 10b-5 of the Exchange Act prohibit corporate insiders from trading in a company's securities on the basis of material nonpublic information (MNPI). Rule 10b5-1(c) provides an affirmative defense to insider trading allegations for corporate insiders who often have access to MNPI, so long as certain conditions are satisfied demonstrating that the MNPI did not factor into the trading decision. In general, the defense provides that the trading decision was not made on the basis of MNPI if the trade was made pursuant to a trading plan adopted at a time that the

insider was not aware of MNPI. However, since the SEC established the affirmative defense in 2000, various groups (including people at the SEC) have raised concerns that the loose rules of Rule 10b5-1(c) allowed insiders to benefit from the liability protection while opportunistically trading securities on the basis of MNPI, including by (among other things) utilizing multiple plans that are effective immediately, and cherry-picking for cancellation plans that have less benefit to the insider. While many (if not most) companies have insider trading policies intended to address some of these concerns, an insider will now have to follow the SEC's new rules in order for the insider to claim an affirmative defense under Rule 10b5-1(c), and company policies should be revised to incorporate these new rules.
Below is a brief summary of the new substantive rules that apply to Rule 10b5-1 plans that are established or modified on or after the date which is 60 days after the date the final rules are published in the Federal Register (such that these new rules will likely be effective in late February / early March of 2023). These new rules will also apply to foreign private issuers.

Cooling-Off Period. Under the final rule, a director or Section 16 officer who adopts, or modifies, a Rule 10b5-1 plan may only rely on the Rule 10b5-1(c) affirmative defense if the plan provides that trading under the plan will not begin until the later of (i) 90 days after adoption (or modification) of the plan or (ii) two business days following the company's disclosure of its financial results in a Form 10-Q or Form 10-K (for foreign private issuers, in a Form 20-F or Form 6-K) for the fiscal quarter in which the plan was adopted or modified (but not to exceed 120 days after adoption or modification of the plan). The cooling-off period for persons other than directors, Section 16 officers, and the company is 30 days. For the moment, the company is not subject to a cooling-off period.

Only certain types of modifications to an existing Rule 10b5-1 plan will trigger a new cooling-off period. A modification to the amount, price, or timing of the purchase or sale of the securities (or a modification to a written formula or algorithm, or computer program that affects the amount, price, or timing of the purchase or sale of the securities) underlying a Rule 10b5-1 plan will be considered a termination of an existing plan and the adoption of a new plan, thus triggering a new cooling-off period.

Director and Officer Certifications. As a condition to the availability of the affirmative defense, a director or Section 16 officer must certify via a representation in the Rule 10b5-1 plan that at the time of the adoption, or modification, of the plan that the director or Section 16 officer is not aware of MNPI about the company or its securities, and the director or Section 16 officer is adopting the plan in good faith and not as part of a plan or scheme to evade the insider trading prohibitions of Rule 10b-5.

Restricting Multiple Overlapping Rule 10b5-1 Plans. With limited exceptions, insiders (other than the company) may generally only have one effective Rule 10b5-1 plan for purchases or sales of any class of securities of the company on the open market during the same period. A series of separate contracts with different broker-dealers under which trades are executed on behalf of an insider may be treated as a single plan if the contracts when taken together meet all of the applicable conditions of and remain subject to Rule 10b5-1(c)(1). However, a modification of any individual contract in the plan will be a modification of each other contract constituting the plan. In addition, a broker-dealer executing trades pursuant to a Rule 10b5-1 plan may be substituted by a different broker-dealer if the purchase or sales instructions applicable to the original broker-dealer and the substitute are identical, including with respect to the price, the dates of purchases or sales to be executed, and the number of securities to be purchased or sold. While the general rule prohibits an insider from having multiple plans outstanding at the same time, the insider may maintain two separate Rule 10b5-1 plans at the same time if trading under the second plan is not authorized to commence until all trades under the first plan are completed or expire without execution, and a cooling-off period (as described above) that begins on the date of termination of the first plan has expired.

An important exception applies to certain "sell-to-cover" transactions whereby an insider executes a sale of securities for purposes of satisfying tax withholding obligations applicable to an equity incentive award, provided the insider does not control the timing of the trade. Therefore, the affirmative defense will remain available with respect to an otherwise eligible Rule 10b5-1 plan if the insider has in place another plan that would qualify for the affirmative defense, so long as

the additional plan or plans only authorize qualified "sell-to-cover" transactions. However, the exception does not apply to sales incident to the exercise of an option award because an insider controls the timing of option exercises. Option exercises must therefore be covered under the insider's primary Rule 10b5-1 plan in order to rely on the affirmative defense.

Single-Trade Plans. If the plan or other trading arrangement is "designed to effect" the open-market purchase or sale of the total amount of securities as a single transaction, the affirmative defense will not be available to an insider (other than the company) unless (i) the person who entered into the plan or trading arrangement has not, during the prior 12-month period, adopted another plan or trading arrangement designed to effect the open-market purchase or sale of the total amount of securities in a single transaction, and (ii) the other plan or trading arrangement was eligible for the affirmative defense. A plan is "designed to effect" the open-market purchase or sale of securities as a single transaction when the plan has the practical effect of requiring such a result. On the other hand, where a plan provides the person's agent with discretion over whether to execute the plan as a single transaction, the plan is not designed to effect the open-market purchase or sale of securities as a single transaction. A plan is also not designed to effect the purchase or sale of securities as a single transaction when the plan, rather than leaving discretion to the agent, provides that the agent's future acts will depend on events or data not known at the time the plan is adopted, and it is reasonably foreseeable at the time the plan is adopted that the plan or trading arrangement might result in multiple transactions

Good Faith. An insider (including the company) who enters into a Rule 10b5-1 plan must act "in good faith with respect to" the plan. The SEC clarified that an insider must act in good faith in establishing the plan and also in the operation of the plan -- including "opportunistic trading" under the plan and not "improperly influencing corporate disclosure to benefit their trades under such a plan". In the SEC's view, this "good faith" requirement applies not only to trades themselves, but to the corporate actions of the insider.

New Disclosure Requirements Regarding Rule 10b5-1 Plans and Insider Trading

One criticism of the Rule 10b5-1 plan regime was that it has operated in the shadows. Neither the insider nor the company has been obligated to disclose the existence of a plan, its terms, or its operation (although some insiders and companies made disclosures voluntarily). This will no longer be the case under the new rules.

Quarterly Disclosure of Trading Plans. The SEC created new mandatory disclosures in Form 10-K and Form 10-Q under Item 408(a) of Regulation S-K to shed light on the use of Rule 10b5-1 plans as well as so-called "non-Rule 10b5-1 trading arrangements". A company will be required to disclose whether, during its last fiscal quarter (the fourth fiscal quarter in the case of an annual report), any director or Section 16 officer has adopted or terminated any plan or other trading arrangement that is intended to satisfy the affirmative defense conditions; and/or any trading arrangement that meets the requirements of a "non-Rule 10b5-1 trading arrangement" as defined in Item 408(c). Companies must also disclose the material terms of the arrangement, other than terms relating to the price at which such trading arrangement is authorized to trade, such as: (i) the name and title of the director or Section 16 officer, (ii) the date of adoption or termination of the plan, (iii) the duration of the plan, (iv) the aggregate number of securities to be sold or purchased under the plan, (v) whether the plan is a Rule 10b5-1 plan or is a non-Rule 10b5-1 trading arrangement, and (vi) any modification or change to a Rule 10b5-1 plan by a director or Section 16 officer that falls within the meaning of new Rule 10b5-1(c)(1)(iv). A "non-Rule 10b5-1 trading arrangement" is a plan that does not meet all the requirements to be a Rule 10b5-1 plan, but the director or Section 16 officer asserts that, at the time the plan was adopted, the director or Section 16 officer was not aware of MNPI about the securities or the company, and the plan (x) specifies the number of securities to be purchased or sold and the price at which, and the date on which, the securities are to be purchased or sold, (y) includes a written formula, algorithm, or computer program for determining the number of securities to be purchased or sold and the price at which they were to be purchased or sold, or (z) does not permit the person to subsequently influence how, when, or whether to effect purchases or sales (provided that any other person who did exercise such influence pursuant to the trading arrangement was not aware of material nonpublic information).

These disclosures will first be required for a Form 10-Q or 10-K that covers a full fiscal period beginning on or after April 1, 2023 (or October 1, 2023 for smaller reporting companies). These disclosures are not required for foreign private issuers.

Annual Disclosure of Insider Trading Policies and Procedures. New Item 408(b) of Regulation S-K (and new Item 16J in Form 20-F for foreign private issuers) will now require companies to disclose on an annual basis whether they have established insider trading policies and procedures that govern the purchase, sale, and other dispositions of their securities by directors, officers, and employees, or the company. The policies and procedures must be designed to promote compliance with insider trading laws, rules, and regulations, and any listing standards applicable to the company. A company that has not adopted such insider trading policies and procedures must explain why it has not done so. Companies will be required to make these disclosures in their annual reports on Forms 10-K and 20-F and proxy and information statements on Schedules 14A and 14C. The company will also need to file a copy of its insider trading policies and procedures as an exhibit to its Form 10-K or 20-F, as applicable.

These disclosures will also first be required for a filing that covers a full fiscal period beginning on or after April 1, 2023 (or October 1, 2023 for smaller reporting companies). These disclosures are required for foreign private issuers.

Identification of Rule 10b5-1(c) Transactions on Forms 4 and 5. The SEC also updated Forms 4 and 5 to add a Rule 10b5-1(c) check box to indicate whether a transaction reported on that form was "intended to satisfy the affirmative defense conditions" of Rule 10b5-1(c). This new check box will be required for Forms 4 and 5 filed on or after April 1, 2023.

Accelerated Reporting on Form 4 of Bona Fide Gifts. While they were at it, the SEC took this opportunity to change the way bona fide gifts of securities are reported on Section 16 reports. Instead of reporting bona fide gifts on a Form 5, gifts will need to be reported on a Form 4. Section 16 reporting persons are required to comply with this change for beneficial ownership reports filed on or after April 1, 2023.

Yet Another Compensation Table and More Narrative Disclosure for Stock Options

Under a new Item 402(x) of Regulation S-K, if, during the company's last completed fiscal year, stock options or stock appreciation rights (SARs) were awarded to a named executive officer (NEO) within a period starting four business days before the filing of a Form 10-Q or Form 10-K, or the filing of a Form 8-K that discloses MNPI (including earnings information), other than a Form 8-K disclosing a material new option award or SAR grant, and ending one business day after the filing, then the company must provide tabular disclosure of the name of the NEO, the grant date of the award, the number of securities underlying the award, the per-share exercise price of the award, the grant date fair value of the award, and the percentage change in the market price of the underlying securities between the closing market price of the security one trading day prior to and one trading day following the disclosure of MNPI.

In addition, a company must provide a narrative disclosure of its policies and practices on the timing of awards of stock options and SARs in relation to its disclosure of MNPI, including how the board determines when to grant such awards, whether, and if so, how, the board or compensation committee accounts for MNPI when determining the timing and terms of an award, and whether the company timed the disclosure of MNPI for the purpose of affecting the value of executive compensation.

While foreign private issuers would not be subject to these new compensation disclosures, domestic smaller reporting companies and emerging growth companies would not be exempt.

These new compensation disclosures will first be required for a proxy statement or Form 10-K that covers a full fiscal period beginning on or after April 1, 2023 (or October 1, 2023 for smaller reporting companies). As a practical matter for calendar year companies, this means the disclosure will not be required until the proxy statement that is filed in 2025 with respect to the 2024 calendar year. That being said, one of the topics already identified by the SEC for discussion in the Compensation Discussion and Analysis (CD&A) is "how the determination is made as to when awards are granted,

including awards of equity-based compensation such as options". Companies may want to embellish the CD&As in their upcoming proxy statements to be filed in 2023 with narrative disclosure that will be required under new Item 402(x). Companies should also plan ahead and review, and make desired changes to, their stock option and stock appreciation rights grant policies in light of the new tabular disclosure under Item 402(x)

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