February 24, 2023

Changes to Conditions of SEC Rule 10b5-1 Obligations

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New amendments to insider-trading regulations are about to go into effect. SEC Rule 10b5-1 has long provided an affirmative defense to insiders who trade under a written plan adopted in good faith and who lack material nonpublic information (MNPI).

Over the years, pundits have noticed that trades under Rule 10b5-1 plans have been unusually profitable, suggesting that some insiders might have misused these plans. As a result, in December 2022, the Securities and Exchange Commission announced amendments and new disclosure requirements to address perceived abuses. Below are the significant provisions that go into effect on February 27, 2023.

New Good-Faith Requirements

Companies have always had to act in good faith when they adopt a Rule 10b5-1 plan. The new amendments extend that obligation, requiring insiders to continue to act in good faith throughout the duration of the plan. *See* 17 C.F.R. § 10b5-1(c)(1)(ii)(A). This means that insiders not only need to act in good faith when creating a plan but also have an obligation to avoid opportunistic trades or timing disclosures that coincide with trades under the plan.

While this is a heightened requirement, it is not clear who will bear the burden of pleading good faith during any ensuing litigation. The regulation is framed as an affirmative defense, but at least one court had previously interpreted the old regulation as placing the burden on the plaintiff to plead facts specifying that a plan was not entered into in good faith or was part of a plan to evade the regulations. [1] It is not clear how courts will interpret the new regulation and whether they will require a pleading of scienter or bad faith for this new obligation.

Director and Officer Certifications

Directors and officers must now certify that (1) they are unaware of any material nonpublic information about the security or issuer and (2) they are adopting the plan in good faith and not as a part of a plan or scheme to evade the regulations.

Cooling-Off Periods

The amendments impose various “cooling-off periods” for trades under Rule 10b5-1 plans, which could vary based on the identity of the trader. These “cooling-off periods” start when a company adopts a new plan or modifies a plan to alter the sale or purchase price, the ranges, the amount of securities sold or purchased, or the time of the trades.

Directors or officers cannot trade under a plan until the later of (a) 90 days after the plan’s adoption or after certain modifications or (b) two business days after filing a Form 10–Q or Form 10–K [2] that discloses the financial results of a quarter in which the plan was adopted or modified (subject to no more than 120 days). Anyone else (non-officers or non-directors) faces a 30-day cooling-off period after any adoption or modification of a plan. [3]

Multiple or Overlapping Plans

A Rule 10b5-1 defense will not be available to anyone who enters multiple or overlapping plans at the same time. This prohibition includes three exceptions:

First, a series of separate contracts with different broker-dealers acting on behalf of a non-issuer may be treated as a single plan if the plans, taken together, meet the regulation's other conditions.

Second, a non-issuer may enter into one subsequent plan for the purchase or sale of any security of the issuer on the open market. But trading cannot begin until after all trades under the earlier starting plan are completed or expired, pending the effective cooling-off period.

Third, eligible sell-to-cover transactions will not be considered outstanding or additional plans under this section. The SEC defines an eligible sell-to-cover transaction as a contract, instruction, or plan that "authorizes an agent to sell only such securities as are necessary to satisfy tax withholding obligations arising exclusively from the vesting of a compensatory award, such as restricted stock or stock appreciation rights, and the insider does not otherwise exercise control over the timing of such sales."

Single-Trade Plans

The final condition imposed by the amendment is the addition of § 10b5-1(c)(1)(ii)(E), which limits the affirmative defense for non-issuers to one single-trade plan designed to affect the open-market purchase or sale of the total amount of securities as a single transaction during a twelve-month period. As with the prior condition, this regulation does exclude eligible sell-to-cover transactions.

Takeaways

Companies, directors, and officers who intend to use a Rule 10b5-1 plan to insulate themselves from accusations of insider trading need to revisit their plans. They need to ensure that the plan articulates a cooling-off period and that the plan includes the director-officer certification. Participants in the plan need to ensure they are conducting themselves in good faith, that they are not joining multiple competing plans during the same period, and that they are abiding by the new restrictions on single-trade plans. Rule 10b5-1 is a powerful tool to insulate insiders from liability, and it is imperative to align these plans with the new regulations.

ENDNOTES

[1] *Arkansas Pub. Emps. Ret. Sys. v. Bristol-Myers Squibb Co*, 28 F.4th 343, 356 n.4 (2d Cir. 2022).

[2] Foreign issuers, Form 20-F or Form 6-K.

[3] The SEC did not impose cooling-off periods on issuers but has suggested that it is investigating whether such a period is appropriate.

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