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SEC's Eye On Exec Trading Plans Should Keep Issuers Wary

By **Dean Seal**

Law360 (June 18, 2021, 9:40 PM EDT) -- Public companies be warned — the U.S. Securities and Exchange Commission's recent drive to overhaul the rule that helps corporate executives dodge insider trading accusations could translate to more scrutiny from the agency's enforcement division, experts told Law360.

Under Rule 10b5-1 corporate stock plans, corporate insiders who may have access to material nonpublic information schedule stock trades at predetermined times to avoid undue scrutiny. SEC Chairman Gary Gensler said earlier this month that the plans have led to "real cracks in our insider trading regime" due to a lack of limitations and disclosure requirements.

The agency said days later that it plans to propose amendments to the affirmative defense against insider trading provided by Rule 10b5-1. And while there have been few SEC enforcement actions involving 10b5-1 plans since the rule was established two decades ago, securities attorneys say that all may change soon.

"There is little doubt that 10b5-1 cases are coming," Kurt Wolfe, of counsel at Quinn Emanuel Urquhart & Sullivan LLP, told Law360. "The staff is reportedly already investigating some instances of potential misconduct, and companies that aren't looking at their policies and procedures — not to mention their executives' plans and practices — are missing a trick."

The Cracks

Gensler's June 7 comments about shortcomings in the current Rule 10b5-1 framework were based in part on research released earlier this year by Stanford University and the Wharton School of the University of Pennsylvania showing that 10b5-1 plans have been used by executives to engage in "opportunistic, large-scale" sales of company stock.

In an examination of more than 20,000 10b5-1 plans, the researchers identified three "red flags" of potential abuse: the use of plans with a short "cooling-off" period between plan adoption and trading, plans that only entail a single trade, and plans that are both adopted and involve trading that occurs before a company's quarterly earnings announcement.

"Sales made pursuant to these plans avoid significant losses and foreshadow considerable stock price declines that are well in excess of industry peers," the researchers said.

Plans that involved a cooling-off period of 60 days or less were associated with measurable loss avoidance that did not materialize for plans with longer periods, the researchers said. Plans that covered a single trade were "consistently loss-avoiding regardless of cooling-off period," unlike multiple-trade plans with a cooling-off period of a month or more, they found.

Some 38% of the 20,000 examined plans executed trades before the earnings announcement for the quarter in which the plans were adopted, according to the researchers, who said those plans "anticipate large losses and foreshadow considerable stock price declines."

The researchers further found that evidence of those abuses has not been publicly available, because the SEC does not require "relatively basic but critical" information about 10b5-1 plans to be publicly disclosed, such as when plans are adopted, modified or canceled.

The SEC also does not require the electronic submission of Form 144, which insiders use to notify the SEC when their 10b5-1 plan is used to sell restricted stock. From 2016 to 2019, 99% of Form 144 filings were submitted by mail and stored at the SEC for 90 days before being destroyed.

Rulemaking Fixes

The research report provides recommendations for fixing these issues, including a ban on single-trade plans, the requirement that Form 144s be electronically filed and posted to the SEC's Edgar database, and mandatory disclosures of the "adoption, modification, suspension or termination of a plan."

"If the trade was made through a plan, then the plan details are going to be readily available at the time of the trade, because the trade was automated," Dan Taylor, a Wharton professor who co-wrote the report, said at the SEC's June 10 investor advisory committee meeting. "So there's not that much burden here to our issuers from these relatively straightforward modifications."

In his June 7 remarks, Gensler suggested reforms in line with the report's call for mandatory disclosure requirements, as well as a minimum cooling-off period, pointing out that his predecessor, Jay Clayton, had suggested a mandated cooling-off period of four to six months.

Gensler said he has asked his staff to also consider limiting the cancellation of 10b5-1 plans. Currently, plans can be canceled at any time regardless of whether the insider has material nonpublic information, which the research report said is "particularly controversial," as executives are able to pause or cancel sales if they are aware of information that will imminently drive up their company's stock price.

"This seems upside-down to me," Gensler said. "It also may undermine investor confidence."

A limit on the number of 10b5-1 plans that corporate executives are allowed to adopt could also be beneficial, he continued, as the ability to enter into multiple plans and then cancel certain ones at will could be misconstrued by insiders as a "'free option' to pick amongst favorable plans as they please."

Gensler's suggestions will likely be reflected in the amendments to Rule 10b5-1 that the agency intends to propose in October, securities attorneys said, and will likely also reflect what are considered "best practices" for the industry. There may be some pushback from public companies on certain parameters, but according to Simpson Thacher & Bartlett LLP partner Steve Cutler, 10b5-1 plans are more of a gift from the government than a right.

"I think companies would probably still say that having some flexibility to do something under a 10b5-1 plan is better than none, which was the state of the world before 10b5-1 was adopted," the former JPMorgan general counsel and SEC enforcement director told Law360.

Investigations Loom

The SEC's interest in reforming Rule 10b5-1 is not necessarily new. Back in 2007, then-enforcement director Linda Chatman Thomsen said publicly that the agency was taking a closer look at 10b5-1 plans, which she said were being misused by Wall Street professionals engaged in "rampant" insider trading.

The rule itself is simply a defense for executives to raise against insider trading allegations, and the SEC can sue over a 10b5-1 plan if it can prove the plan was used in bad faith.

That said, the regulator hasn't made any revisions to the rule since it was adopted in 2000, and there has been scant policing of 10b5-1 plans from the agency's enforcement division. There could be several reasons for that, attorneys said. It can be difficult to show that an insider acted in bad faith, a lack of data around 10b5-1 trades may have made it hard to bring cases, or such cases may simply not have been a priority under previous administrations.

But a glut of reporting on insider trading in the past year — some of which, Wolfe of Quinn Emanuel pointed out, "identified at least questionable trading or 10b5-1 practices by executives at several public companies" — along with emerging research on the subject, has pushed 10b5-1 plans back in the spotlight. And no chairman may be more primed to address them through enforcement than Gensler, attorneys said.

"It makes sense that it is happening now," Kyle DeYoung, a partner at Cadwalader Wickersham & Taft LLP, told Law360. "Chair Gensler is expected to take a more aggressive approach to regulation and enforcement across the board."

Gensler said on June 7 that consistently requiring what are already considered "best practices" regarding 10b5-1 plans would be a step in the right direction, but that the agency would "use all of the tools in our toolbox to ensure we are identifying and punishing abuses of 10b5-1 plans."

"Chair Gensler's remarks suggest that he believes there are executives who are committing insider trading by abusing Rule 10b5-1 plans, and I would be surprised if enforcement is not focusing on this issue now," DeYoung said.

One of the enforcement division's best tools for cracking down on 10b5-1 plans will be its ability to identify suspicious trading activity using data analytics, several attorneys said. The agency is increasingly employing data analytic tools to identify anomalous trading, according to Mayer Brown LLP partner Marlon Paz, who added that, "given the current interest, it is safe to infer that there is focus on trading by senior executives."

Wolfe also noted that the agency has access to the corporate disclosures showing when executives create or amend a 10b5-1 plan, and when coupled with the SEC's data analytics tools, can "start connecting the dots."

"[That's] not to say that the creation or amendment of a plan will necessarily be a problem that leads to

an enforcement action, but even an investigation is an unwanted development," Wolfe said. "Given that Gensler seems to be focusing on this area, there will undoubtedly be more investigations. They won't all come up dry."

--Editing by Jill Coffey and Nicole Bleier.
