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Rule 10b5-1: Change Is Coming to the Insider Trading Regime – Or Is It Already Here?

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In December 2021, the Securities and Exchange Commission ("SEC") proposed amendments to Rule 10b5-1 meant to address potential abuses of the current insider trading regime. As the SEC contemplates the final form of these amendments, it has already begun to crack down on improper reliance on or abuse of Rule 10b5-1 from an enforcement perspective. In the last few months, both the SEC and Department of Justice ("DOJ") have reportedly prioritized investigations of Rule 10b5-1 trading plan abuses, and it's likely that heightened enforcement challenging claims of reliance on Rule 10b5-1 (whether in its current form or as amended) is soon to follow.

Proposed Changes to Rule 10b5-1

Rule 10b5-1(c) under the Securities Exchange Act of 1934 provides an affirmative defense to insider trading for parties, such as corporate executives and directors, that often have access to material nonpublic information about their companies. Rule 10b5-1(c) provides a means for these parties to sell their company stock without violating Rule 10b-5's prohibition on insider trading so long as any trades are made pursuant to pre-determined trading plans, known as Rule 10b5-1 plans, that are entered into a time when such parties are not aware of material nonpublic information.[i]

Rule 10b5-1 has long been criticized as allowing opportunistic trading and being subject to manipulation. Citing the need to "address critical gaps in the SEC's insider trading regime," the SEC proposed amendments to Rule 10b5-1 in December 2021.[ii] The amendments are targeted at enhancing protections against insider trading by making the requirements more restrictive, including by requiring 120-day cooling off periods before an executive officer's or director's trades can be executed under new or modified plans, prohibiting overlapping plans for the same class of securities, limiting single-trade plans to one plan per 12-month period, and requiring insiders to certify that they are not aware of material nonpublic information prior to adopting or modifying a new plan.[iii] The requirement that a 10b5-1 plan be entered into in good faith would be expanded to require that the plan also be operated in good faith.[iv] The amendments would also introduce multiple new reporting requirements pertinent to insider trading, including with respect to issuer's insider trading policies and the usage of Rule 10b5-1 plans by insiders.[v] In its regulatory agenda published in June 2022, the SEC indicated that it planned to adopt the final amendments by April 2023.[vi]

Signs of Heightened Enforcement Activity

In addition to proposing amendments aimed at curbing alleged abuses of Rule 10b5-1, the SEC—together with the DOJ—has also recently demonstrated an increased interest in investigating and enforcing potential abuses of the rule. Historically, trades made in reliance on Rule 10b5-1 have only been infrequently investigated by U.S. authorities. However, according to recent reports, the DOJ's Fraud Section and SEC enforcement attorneys are now using computer algorithms to identify potential manipulations of

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Rule 10b5-1 plans, and there are some indicators in the market that these investigations have been fruitful.[vii] In September, the SEC reached a settlement with the CEO and the former President of Cheetah Mobile Inc. based on allegations that the two executives sold stock pursuant to a 10b5-1 plan that they entered into while they were aware of material nonpublic information that the company's second quarter revenue would be lower than expected.[viii] By selling shares before the public disclosure of the negative revenue report, the executives avoided losses of approximately $300,000.[ix] Not only does this settlement indicate that insider trading enforcement is likely on the rise, it also demonstrates that the SEC will investigate and punish infractions that result in relatively small benefits for insiders. In addition, the SEC's order stipulated that for a period of five years following the order, the CEO would include a 120-day cooling off period for trading under any new or modified Rule 10b5-1 plan, and would not maintain overlapping plans, with respect to Cheetah Mobile securities.[x] The inclusion of these restrictions in the order suggests that the SEC remains supportive of including these restrictions in the final Rule 10b5-1 amendments, as proposed.

Other signs of robust investigations suggest that increased enforcement activity is on the horizon. In October, a breast-implant company disclosed that it had received subpoenas from DOJ and the SEC seeking materials related to its former CEO's trading activities.[xi] And, while other companies have yet to publicly disclose similar requests, we are aware that other market participants have also noticed a sudden increase in inquiries from the SEC and DOJ regarding 10b5-1 plans. In light of these indicators, companies and corporate insiders should be particularly scrupulous when adopting Rule 10b5-1 plans, remain mindful of actions or provisions that could attract scrutiny or that underlie concerns prompting the proposed SEC amendments, and consult with counsel to reduce the risk of potential investigation and enforcement.

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[i] *See* 17 CFR § 240.10b5-1.

[ii] U.S. Sec. & Exch. Comm'n, SEC Proposes Amendments Regarding Rule 10b5-1 Insider Trading Plans and Related Disclosures (Dec. 15, 2021), https://www.sec.gov/news/press-release/2021-256.

[iii] *See* Gibson Dunn Client Alert, SEC Proposes Rules on Insider Trading, Rule 10b5-1 and Share Repurchases (Dec. 23, 2021).

[iv] *Id.*

[v] *Id.*

[vi] U.S. Sec. & Exch. Comm'n, Rule 10b5-1 and Insider Trading (2022), https://www.reginfo.gov/public/do/eAgendaViewRule?pubId=202204&RIN=3235-AM86.

[vii] Bloomberg, US Probes Insider Trading in Prearranged Executive Stock Sales (Nov. 3, 2022).

[viii] U.S. Sec. & Exch. Comm'n, Order in the Matter of Sheng Fu and Ming Xu (Sep. 21, 2022).

[ix] *Id.*

[x] *Id.*

[xi] Bloomberg, US Probes Insider Trading in Prearranged Executive Stock Sales (Nov. 3, 2022).

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