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New Bill Aims to Curtail Covert Insider Trading

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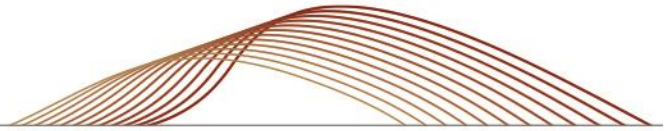
Insider trading remains a bedrock of the SEC enforcement program. Roughly 10% of cases brought annually by the SEC's Division of Enforcement involve insider trading allegations. Without a potential landmark insider trading case on the Supreme Court's calendar for 2019, one of the more interesting enforcement-related developments this year may stem from proposed federal legislation regarding the use of Rule 10b5-1 trading plans.

Specifically, on January 18, 2019, Congresswoman Maxine Waters (D-Calif.) and Congressman Patrick McHenry (R-N.C.) jointly introduced the *Promoting Transparent Standards for Corporate Insiders Act* (H.R. 624), which would direct the SEC to study certain issues involving 10b5-1 trading plans.

Rule 10b5-1 under the Securities Exchange Act of 1934 (17 C.F.R. § 240.10b5-1) defines when a purchase or sale of a security is "on the basis of" material nonpublic information and therefore may constitute insider trading, and establishes affirmative defenses against insider trading. Specifically, Rule 10b5-1 provides that trades are not considered to be executed on the basis of material nonpublic information if the insider can demonstrate that, before becoming aware of material nonpublic information, the person: (1) entered into a binding contract to trade; (2) directed another individual to trade on such person's behalf; or (3) adopted a written plan for trading securities. The rule was enacted by the SEC to protect insiders from misplaced insider trading accusations arising from innocuous trades that merely appeared improper because of coincidentally advantageous timing. Under the rule, a person can adopt a written trading plan to sell a predetermined number of shares at a prearranged time, provided that such person is not in possession of material nonpublic information at the time the plan is adopted.

While a defendant facing SEC insider trading charges has the burden of establishing that a 10b5-1 plan was properly implemented, and courts have shown an increased willingness to examine the legitimacy of these plans, the mere existence of a well-drafted 10b5-1 plan can provide a robust affirmative defense in defense of SEC insider trading allegations.

The benefits of 10b5-1 plans extend beyond mitigating risk of SEC enforcement actions; they also provide protection against liability in private litigation. For example, in January 2016, investors in Tetraphase Pharmaceuticals filed a complaint naming the corporation and three individual officers as defendants in a securities fraud suit. The plaintiffs attempted to show the officers' intent to commit fraud by introducing evidence regarding the defendants' "suspicious" trading during the relevant time period. In response, the defense successfully showed that, in fact, the trades were made pursuant to legitimate 10b5-1 plans. The court ultimately dismissed the plaintiffs' complaint and noted that, while



not dispositive, 10b5-1 plans "rebut[ ] an inference of scienter and support[ ] the reasonable inference that stock sales were prescheduled and not suspicious."

Some corporate insiders, however, have been accused of manipulating 10b5-1 plans in order to enable and disguise insider trading, often by making changes to their 10b5-1 plans while in possession of material nonpublic information or by having multiple plans in place simultaneously. In 2009, the SEC brought a well-publicized enforcement action accusing a CEO of routinely amending his 10b5-1 plans to engage in insider trading despite the plans. The case, which involved numerous other unrelated allegations, ultimately settled and resulted in what was, at the time, the highest settlement amount obtained against a public company senior executive in the history of the SEC's enforcement program.

Perhaps not coincidentally, on March 25, 2009, the SEC's Division of Corporation Finance released guidance on Rule 10b5-1, specifically concerning cancelling or establishing a replacement trading plan among other issues.

In an effort to curb perceived abuse of Rule 10b5-1 plans by insiders, the bill recently introduced in the House may end up limiting the availability of 10b5-1 plans and of associated affirmative defenses. The bill directs the SEC to carry out a yearlong study of 10b5-1 plans and determine whether certain restrictions should be put in place to prevent misuse. The study would review whether Rule 10b5-1 should be amended to:

- restrict the ability to adopt certain plans at certain times;
- limit the number of plans that may be adopted by any individual or company;
- restrict the ability to amend or cancel plans after their enactment;
- create a mandatory delay between the adoption of a plan and the first trade made pursuant to that plan; and
- require certain filings with the SEC to facilitate federal oversight of these plans.

H.R. 624 is the first bipartisan piece of legislation introduced by Maxine Waters, new Chairwoman and Ranking Member of the House Financial Services Committee for the 116th Congress, and McHenry, the Committee's Ranking Republican. The bill symbolizes a bipartisan willingness to work on financial services legislation in the House. "Cracking down on fraud and abuse within our financial system is apolitical," said McHenry in a statement. The legislation is scheduled for House Floor consideration this week and will likely pass overwhelmingly. While strong passage in the House will give the bill a better chance of passage in the Senate, Republicans in the Senate may have concerns about giving the SEC broad rulemaking authority.

In addition to receiving widespread bipartisan support, the bill is supported by the Council for Institutional Investors and Public Citizen. If enacted, any resulting changes to Rule 10b5-1 promulgated by the SEC following its study would likely have a major impact given the wide-spread adoption of 10b5-1 plans.

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