Committee on Securities Law
of the Business Law Section of the
Maryland State Bar Association

April 4, 2022

VIA EMAIL AT RULE-COMMENTS@SEC.GOV

Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: Rule 10b5-1 and Insider Trading (Proposed Amendments), File No. S7-20-21

Ladies and Gentlemen:

This letter expresses the views of the Committee on Securities Law (the "Committee") of the Business Law Section of the Maryland State Bar Association ("MSBA") with respect to the above-referenced proposing release, SEC Release Nos. 33-11013; 34-93782; File No. S7-20-21 (sometimes referred to herein as the "release") relating to the Securities and Exchange Commission's (the "Commission") proposed amendments to Rule 10b5-1 ("Rule 10b5-1") under the Securities Exchange Act of 1934 ("Exchange Act"). The membership of the Committee consists of securities practitioners who are members of the MSBA and includes lawyers in private practice, business, government, and academia. The Business Law Section and the Board of Governors of the MSBA have not taken a position on the matters discussed herein, and individual members of the MSBA and the Committee, and their associated firms or companies, may not necessarily concur with the views expressed in this letter.

We believe that the proposed amendments include a number of common-sense revisions to the requirements set out in paragraph (c) of Rule 10b5-1 with respect to Rule 10b5-1 trading arrangements (as such term is used in the release). For example, we support a cooling-off period, as proposed, between the date that a 10b5-1 trading arrangement is entered into and the date that a first trade can be made under the plan (although we are not taking a position on whether the length of the proposed cooling-off periods are appropriate) and the proposed restrictions on multiple overlapping Rule 10b5-1 trading plans and single-trade arrangements. We have concerns, however, with a number of other provisions of the proposed amendments.

I. Director and Officer Certifications

We are particularly concerned with the proposed director and officer certifications. As proposed, a director of officer who adopts a Rule 10b5-1 trading arrangement, "as a condition to the availability of the affirmative defense, . . . would be required to promptly furnish to the issuer a written certification . . . at the time of the adoption of a new/modified trading arrangement." Such "certification would require a director or officer to certify at the time of the adoption of the trading arrangement" that, among other things, "they are not aware of material nonpublic information about the issuer or its securities." According to the release, this "proposed certification requirement is intended to reinforce directors' and officers' cognizance of their obligation not to trade or adopt a trading plan while aware of material nonpublic information."

The concept that the affirmative defense provided by Rule 10b5-1(c) requires that persons entering into a trading arrangement must not be aware of any material nonpublic information at the time they enter into the arrangement appears throughout the release, as well as in other guidance issued by the Commission and the Division of Corporation Finance since the adoption of Rule 10b5-1 in 2000. For example, the release states in the third paragraph of Part I, "Rule 10b5-1(c) established an affirmative defense to Rule 10b-5 liability for insider trading in circumstances where it is apparent that the trading was not made on the basis of material nonpublic information because the trade was pursuant to a binding contract, an instruction to another person to execute the trade for the instructing person's account, or a written plan … adopted when the trader was not aware of material nonpublic information."

This is not, however, what Rule 10b5-1(c) actually provides. As the release acknowledges, Rule 10b5-1 (in paragraph (b)) states that, for insider trading purposes, "a purchase or sale of a security of an issuer is 'on the basis of' material nonpublic information about that security or issuer if the person making the purchase or sale was aware of *the* material nonpublic information when the person *made the purchase or sale*" (emphasis added). Correspondingly, Rule 10b5-1(c)(A) provides that the affirmative defense is available, assuming the other requirements of Rule 10b5-1(c) are complied with, "if the person making the purchase or sale demonstrates that . . . [b]efore becoming aware of *the* information, the person had" entered into the applicable trading arrangement (emphasis added). Therefore, contrary to the Commission's assertion in the release, Rule 10b5-1(c) does not state that the affirmative defense is available if the trader adopted the trading arrangement when he or she "was not aware of material nonpublic information." Instead, Rule 10b5-1(c) states that the affirmative defense is available if the trader adopts the trading arrangement when he or she was not aware of "the" information—that is, the "material nonpublic information about the security or issuer . . . when the person made the purchase or sale" as set forth in paragraph (b) of Rule 10b5-1. There is no basis for the assertion that the reference in Rule 10b5-1(c)(A) to "the information" actually means "any material nonpublic information."

Further, this position is contradictory to insider trading jurisprudence, which imposes liability based on "the purchase or sale of a security of any issuer on the basis of material nonpublic information about that security or its issuer, in breach of a duty owed directly, indirectly, or derivatively, to the issuer of that security or the shareholders of that issuer, or to any person who is the source of the material nonpublic information."[1] Both Rule 10b5-1 and the release acknowledge this as well. As noted in the release, "Rule 10b5-1 . . . provid[es] that a purchase or sale of an issuer's security is on the basis of material nonpublic information about that security or issuer for purposes of Section 10(b) if the person making the purchase or sale *was aware* of material nonpublic information when the person made *the purchase or sale*" (second emphasis added).

In sum, whether trading activity could possibly constitute illegal insider trading under Section 10(b)(5) of the Exchange Act is based on the information that the trader was aware of *at the time of the trade*. We are not aware of any instance, outside of guidance and discussion related to Rule 10b5-1(c), where it has been suggested that material nonpublic information that a trader was aware of at the time he or she made the *decision* to purchase or sell a security, as opposed to at the time such a purchase or sale was actually made, has any relevance in determining whether specific trading activity constitutes illegal insider trading. Any requirement that a trader not be aware of any material nonpublic information when a Rule 10b5-1 trading plan is entered into is thus inconsistent with the history and jurisprudence regarding illegal insider trading. We believe that the Commission subtly acknowledges this by not proposing to amend Rule 10b5-1(c) to provide that the affirmative defense is only available if the person making the trade entered into the trading arrangement when the person was not aware of any material nonpublic information about the security or the issuer. Rather, as proposed to be amended Rule 10b5-1(c) would retain the existing language that the trader enter into the Rule 10b5-1 trading arrangement "[b]efore becoming aware of *the* information." (emphasis added).

[1] See text surrounding note 7 of the release.

Given the above, we believe that it is inappropriate to require insiders to submit certifications that are inconsistent with the concept of illegal insider trading and, further, is <u>not</u> required by Rule 10b5-1(c) *even as it is proposed to be amended*.

Instead, we suggest that the requirement should be that the affirmative defense is only available if either (i) the trader was not aware of any material nonpublic information about the issuer or the security when he or she entered into the 10b5-1 trading arrangement, <u>or</u> (ii) any such material nonpublic information is either public or no longer material at the time of the trade. This requirement would be consistent with the purpose of the illegal insider trading prohibition, which is to not allow insiders to trade on the basis of material nonpublic information to their advantage. By requiring that any material nonpublic information that the trader had when the plan was entered into be either public or not material on the date of the trade, there would be no informational asymmetry between insiders and non-insiders when the trade is consummated. Although it is possible that any such material nonpublic information that the trader assumed would be public or not material at the time of the trade fails to be public or immaterial at such time, he or she could simply cancel the trading arrangement to avoid any insider trading liability. If the proposed certification requirement is retained, we suggest that the certification require the trader to certify that he or she would in fact cancel the affected trade(s)/trading plan under these circumstances, which would be consistent with the purpose of Rule 10b5-1(c), without making compliance needlessly difficult.

Further, changing the proposed certification requirement in this manner would make compliance with the requirements of Rule 10b5-1(c) possible as a practical matter. For many insiders, finding a point in time where they are not aware of any material nonpublic information about the issuer or the issuer's securities is extremely difficult. Again, the Commission subtly acknowledges this by proposing a 120-day cooling-off period for Rule 10b5-1 trading arrangements adopted by insiders. If traders were entering into trading arrangements at a time when they were not aware of any material nonpublic information, there would be no purpose in requiring the cooling-off period. In most instances, any material nonpublic information that an insider would be aware of when he or she adopts a Rule 10b5-1 trading arrangement will have ceased to be material nonpublic information 120 days later. As a result, the requirement that insiders enter into such a plan when they are not aware of material nonpublic information is redundant and unnecessarily restrictive. We believe that the proposed cooling-off period is a more effective way to address the concerns cited in the release.

The requirement that a Rule 10b5-1 trading arrangement be entered into at a time the trader is not aware of material nonpublic information has become a generally accepted part of the affirmative defense. The Commission's proposal, however, would institute a number of changes to Rule 10b5-1(c) despite the current practices having been in place for over two decades, including the proposed cooling-off period that makes this requirement unnecessary. Further, the idea that the affirmative defense provided by Rule 10b5-1(c) is only available if the trading arrangement is entered into when the trader was not aware of any material nonpublic information was not part of Rule 10b5-1(c) when it was adopted and was not discussed as being a requirement of the affirmative defense in the release initially proposing the adoption of Rule 10b5-1 (or, for that matter, in the adopting release). Rather, the idea that a person adopting a Rule 10b5-1 trading arrangement must not be aware of any material nonpublic information at the time the plan is adopted was first set forth in interpretive guidance published by the staff of the Commission's Division of Corporation Finance after the rule was finalized, which shortly thereafter added language to Form 144 that was consistent with such guidance. And, over the last 20 years, this has been repeated so frequently that it is likely that many people have assumed that this is true—that this is what the rule provides. As this requirement was not part of the original rule proposal, however, the requirement itself, and the Staff's analysis of why it is appropriate, was never subject to public comment or analyzed in compliance with the Administrative Procedures Act, including the required cost-benefit analysis. As a result, we believe that it would be inappropriate to justify including this requirement on the basis that it has been a long-accepted part of the affirmative defense.

We also understand that permitting issuers and insiders (and others) to enter into a Rule 10b5-1 trading arrangement while aware of material nonpublic information would sound problematic to persons who are not privy to the intricacies of insider trading liability and the nuances of the affirmative defense, (*e.g.*, the difference between being aware of material nonpublic information at the time a trading arrangement is adopted and at the time a trade is executed). However, the provisions of the affirmative defense should not be driven by such knee-jerk reactions of persons who, without such understanding, will simply assume and assert that what we propose would allow insiders to trade on the basis of material nonpublic information with impunity. We understand that if the Commission adopted the change to the certification that we propose, it may face criticism that it is unconscionable to allow insiders to enter into these plans while aware of material nonpublic information. But such criticism would be based on the general misunderstanding that this would be equivalent to allowing insiders to trade while aware of material nonpublic information because it would provide them "cover" for trades under the trading arrangement—which is not the case. Further, to the extent that Rule 10b5-1 trading arrangements are being (or would be) misused, then the trader would be liable for illegal insider trading. Contrary to popular belief, the adoption of a Rule 10b5-1 trading arrangement does not provide an impenetrable shield to all charges of insider trading.

A trader's knowledge at the time his or her *decision* to trade is made, as opposed to the time the trade itself is made, is largely irrelevant to the question of whether illegal insider trading has occurred. As a result, the trader's knowledge at the time he or she enters into a Rule 10b5-1 trading arrangement—the time the decision to trade is made—is similarly irrelevant and should not drive the requirements of the availability of the affirmative defense. Therefore, we respectfully ask the Commission to carefully consider this matter and to include requirements to the affirmative defense in a manner that is consistent with its purpose, insider trading jurisprudence, and Rule 10b5-1 itself.

II. Additional Disclosures Regarding Rule 10b5-1 Trading Arrangements - Quarterly Reporting of Rule 10b5-1(c) and Non-Rule 10b5-1(c) Trading Arrangements

Proposed new Item 408(a) of Regulation S-K would require quarterly disclosure regarding the use and material terms of trading arrangements by a registrant and its directors and officers for the trading of the registrant's securities. The disclosures would include "whether or not [the trading arrangement is] intended to satisfy the affirmative defense conditions of Rule 10b5-1(c)." We have a number of concerns with this part of the proposal.

First, the proposal assumes that a registrant's or insider's adoption of a Rule 10b5-1 trading arrangement is per se material. We do not believe that this is necessarily true, especially when any sales or purchases pursuant to these arrangements would be reported on a Form 4 within two business days. To the extent that the proposed disclosure requirements are adopted, we believe that it would be appropriate that they (at the very least) be subject to a materiality standard.

We also urge the Commission to exempt smaller reporting companies from the proposed disclosure requirement. Smaller reporting companies and their insiders are less likely to engage in the kinds of trading in the securities of their companies that would cause concern, yet the burden of providing this disclosure on a quarterly basis would disproportionately affect smaller reporting companies. Smaller reporting companies often lack the necessary personnel to comply with the ever-expanding disclosure requirements, and, in this case, we do not believe that the burden on smaller reporting companies would be outweighed by any expected benefits to their investors of providing this information.

Second, as justification for these new disclosure requirements, the release indicates that "[s]uch disclosures would allow investors to assess whether, and if so, how, issuers monitor trading by their directors and officers for compliance with insider trading laws and whether their compliance programs are effective at preventing the misuse of material nonpublic information." The release also states that "[t]he lack of comprehensive public information about the use of these arrangements by officers, directors, and issuers . . . deprives investors of the ability to assess whether those parties may be misusing their access to material nonpublic information." We do not understand how disclosure of the adoption and operation of trading arrangements (especially by the registrant itself) relates to issuers monitoring trading by their officers and directors for compliance with insider trading laws and whether their compliance programs are effective at preventing the misuse of material nonpublic information. Further, the idea of providing this information so that investors can assess issuers and their officers' and directors' compliance with insider trading laws is unnecessary. The purpose of the disclosure requirements of the federal securities laws is to provide investors with the information that they need to make investment decisions.[2] It is not to deputize an army of investors, not to mention anybody with Internet access, to police registrants' and their officers' and directors' compliance with applicable laws.

We do not believe that it is appropriate for the Commission to take the position that this is an appropriate role for investors and the general public under the federal securities laws and implement disclosure requirements to further this goal. In addition, to the extent that the Commission believes that this is an appropriate role for investors, it seems that there would be more important laws that investors would want to make sure registrants are complying with (*e.g.*, consumer safety laws, anti-money laundering and know your customer requirements for financial institutions—laws that noncompliance with could materially impact the registrant's business and operations).

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[2] *See, e.g.*, "Securities Act of 1933" discussion on the Commission's Investor.gov website, available at https://www.investor.gov/introduction-investing/investing-basics/role-sec/laws-govern-securities-industry#secact1933 (providing that the basic objective of the Securities Act of 1933 is to "require that investors receive financial and other significant information concerning securities being offered for public sale").

The release also states that the Commission is proposing such disclosure with respect to trading arrangements outside of the Rule 10b5-1(c) affirmative defense based on its "recogni[tion] that[,] as a result of the proposed amendments[,] some issuers, directors or officers may seek to execute sales or purchases through trading arrangements that do not satisfy the conditions of Rule 10b5-1(c)(1)." The Commission is correct that the proposed changes to Rule 10b5-1 and the proposed disclosure requirements would make it less likely that some issuers, directors, and officers will enter into trading arrangements that satisfy the conditions of the affirmative defense. This is hardly justification, however, for imposing disclosure requirements with respect to trading arrangements not intended to take advantage of the affirmative defense. If the primary concern is the potential misuse of the affirmative defense, then information about trading arrangements not intended to take advantage of the affirmative defense would not be relevant, let alone material. Further, to the extent that the concern is about the misuse of material nonpublic information in connection with trading by registrants and insiders generally, and/or ensuring that investors can assess whether registrants and insiders are complying with the illegal insider trading prohibitions of the federal securities laws, then requiring information about all the trading arrangements, but not all securities trades generally, would not address these concerns either.

We are further concerned that the release and the proposed amendments do not shed any light on what might constitute a trading arrangement not intended to satisfy the conditions of Rule 10b5-1(c). Without more specificity as to what is not considered a trading arrangement, this requirement could (and likely would) be deemed to cover any trading by insiders, except trades a person self-executes on their own laptop, pad, or other device without any forethought (such as any instruction to the trader's broker to buy or sell the issuer's securities). We do not believe this disclosure is necessarily material or appropriate. To the extent that the Commission retains this proposed disclosure requirement, however, we believe that Item 408 of Regulation S-K should include a definition, or at least guidance, as to what constitutes a "non-Rule 10b5-1 trading arrangement." The definition should be as narrow as is possible to address the concerns the disclosure requirement is purporting to address. Without such specificity and narrow definition, the Commission risks a situation where registrants are compelled to provide a quarterly list of all insider trades, which would not only duplicative information (*i.e.*, already provided on Form 4), but would add unnecessary information to documents that in many cases are already quite lengthy and take a significant portion of management's time to prepare. We believe that management's time—a finite resource—would be better spent focusing on the disclosure of information that is material to investors.

We also believe that it is important to note that there is no existing requirement that insiders submit their trading arrangements to the issuer with whom they are employed or on whose board of directors they serve. Although it is common for issuers to require that insiders submit to the issuer any Rule 10b5-1(c) trading arrangements for review prior to entering into such arrangement, no law, rule, or regulation requires them to do so. The proposed disclosure requirement would not only require issuers to obtain and review all insider Rule 10b5-1(c) trading arrangements, it would require issuers to review of all trading arrangements of their insiders prior to entry into such plans. Particularly in light of the potential broad interpretation of what might constitute a trading arrangement that is not intended to satisfy the affirmative defense conditions of Rule 10b5-1(c), this could be an overwhelming amount of information that issuers will have to collect, review, and disclose.

We are also concerned that plaintiffs' attorneys will use this requirement to assert that issuers have liability for any violative trades under such trading arrangements due to their collection and review of those arrangements. We do not believe that there is any benefit to this obligation, and it provides significant risks to, and burdens on, registrants. We believe that this is particularly true given the dearth of evidence that illegal insider trading under the guise of Rule 10b5-1 trading arrangements is rampant. The release refers generally to "concern[s] that the affirmative defense under Rule 10b5-1(c)(1)(i) has allowed traders to take advantage of the liability protections provided by the rule to opportunistically trade securities on the basis of material nonpublic information" and "trading practices by corporate insiders and issuers that suggest the misuse of material nonpublic information." The release contains, however, startingly little hard evidence to back this up. For instance, we note the reference to "some academic studies of Rule 10b5-1 trading arrangements have shown that corporate insiders trading pursuant to Rule 10b5-1 consistently outperform trading of executives and directors not conducted under a Rule 10b5-1 trading arrangement." We do not believe that such correlation means that it is appropriate to conclude that the misuse of material nonpublic information is responsible for these differences. Further, to the extent that this was true, the affirmative defense would not be available, and the insiders would be liable for trading on the basis of material nonpublic information.

Entry into a Rule 10b5-1(c) trading arrangement does not provide unquestionable cover for any trades thereunder, which appears to be a common misperception if public and media statements surrounding this issue are any indication. If there was significant misuse of Rule 10b5-1(c) trading arrangements in this manner, we would expect that there would have been a rash of enforcement cases for insider trading liability in connection with the use of these arrangements. There has not been. This suggests that such "misuse" is not widespread enough to justify such onerous disclosure requirements.

Other referenced concerns can (and under the proposed amendments would) be addressed by more targeted and less onerous measures, including, in this case, by the proposed amendments that would prohibit these practices. This would make additional requirements, such as the proposed disclosure requirements, unnecessary to address such concerns. Further, it is entirely inappropriate to base any new disclosure or other requirements on "concerns [that] have been raised about issuers abusing Rule 10b5-1(c)(1) plans to conduct share repurchases to boost the price of the issuer's stock before sales by corporate insiders" when the Commission staff's own research suggests that this is not happening.[3] In addition, to the extent that any trading arrangement is not intended to comply with the affirmative defense of Rule 10b5-1(c), the concerns expressed in the release are irrelevant and do not justify the proposed disclosure requirements with respect to these arrangements.

Finally, while the release provides that the proposed quarterly disclosure is only required if a trading arrangement was actually adopted during the quarter in question, this is not clear from the text of proposed Item 408(a) itself. The text provides that registrants are required to "[d]isclose whether … any director or officer … has adopted any contract, instruction or written plan for the purchase or sale of securities of the registrant" and includes corresponding language with respect to such arrangements adopted by the registrant. To the extent that Item 408(a) is included in the final amendments, we suggest that the Commission clarify in Item 408(a), or at least an instruction thereto, that the proposed disclosure is only required if such an arrangement has been adopted or terminated during the applicable quarter.

III. Disclosure Regarding the Timing of Option Grants and Similar Equity Instruments Shortly Before or After the Release of Material Nonpublic Information

Proposed new Item 402(x)(2) of Regulation S-K would require certain tabular disclosures if a registrant grants stock options and similar awards to a

[3] *See* SEC Staff Response to Congress: Negative Net Equity Issuance, December 2020, available at https://www.sec.gov/files/negative-net-equity-issuance-dec-2020.pdf, p. 45. ("these findings potentially suggest that most repurchase activity does not represent an effort to artificially inflate stock prices or influence the value of option-based or EPS-linked compensation").

named executive officer within 14 days before or after the filing of a quarterly report on Form 10-Q or an annual report on Form 10-K, an issuer share repurchase, or the filing or furnishing of a current report on Form 8-K that discloses material nonpublic information. We have a number of concerns regarding this proposal.

In particular, the release provides that the 14-day period is "designed to cover the period that a company would be aware of material nonpublic information" during the approximate one- or two-week period after the end of a fiscal quarter, but before the company puts out its earnings release when that company's board of directors would typically meet and be aware of material nonpublic information. This, however, ignores the fact that in many cases a company will not be aware of material nonpublic information that is disclosed in a Form 8-K 14 days before the filing of such Form 8-K, which requires disclosure of a number of events within *four business days* after the occurrence thereof. Further, in most cases, as this language in the release acknowledges, registrants will publish an earnings release that discloses all material information with respect to the most recently completed fiscal year or quarter well in advance of filing their periodic report on Form 10-K or 10-Q. Under these circumstances, it does not make sense to require the proposed disclosure for awards granted within 14 days of the filing of a Form 10-K or 10-Q.

With respect to awards granted after the release of material nonpublic information, the 14-day period is extreme (at best). Once the information is released and the market has absorbed that information, an insider who trades while aware of such information would no longer be trading "on the basis of material nonpublic information." Similarly, once the market has absorbed the material nonpublic information in question, it would not be "bullet-dodging" to grant options at the fair market value on the date of the grant. We are not aware of any basis by which one could assert that 14 days is the appropriate amount of time it takes for the market to absorb material nonpublic information once it is released—based on publicly-available insider trading plans, as well as our own experience, this is considered to take a few days at most.

Further, many awards are made at a standard or routine time, such as on the date of a registrant's annual meeting or the first meeting of its compensation committee following the end of the prior fiscal year, in which case the grant of such awards within 14 days of the registrant's release of material nonpublic information would be purely coincidental. Yet in all of these instances, the new disclosure requirement would, by implication, ascribe a nefarious intent to the equity award grants in question. Moreover, the 14-day period is inconsistent with the purported practice of "[t]iming option grants to occur *immediately* before the release of positive material nonpublic information," which the release defines as "spring-loading," which is one of the practices that the proposed new disclosure requirements are aimed to address.

There can be many innocent reasons, including for those noted above, that a registrant may grant options or similar equity awards within 14 days before or after the release or material nonpublic information with no intention of benefiting the recipients thereof through the use of the "bullet-dodging" or "spring-loading" timing issues that are the focus of the proposed disclosure requirements. The simple act of requiring disclosure of these grants in the manner proposed, however, will imply a nefarious intent and wrongdoing on the part of the registrant, which in many cases will be incorrect and, potentially, materially misleading. While the usual remedy for this would be disclosure on the part of the registrant, we believe that the sensitive political atmosphere regarding executive compensation and insider trading would fail to cut through the "sound bites" implying wrongful behavior with respect to the grant of these awards. We further believe that this part of the proposal is problematic and cannot be revised in a way that would make it appropriate to adopt, such that the benefits of the disclosure would outweigh the costs and risks.

We do believe, however, that the proposed narrative disclosure that would be required by proposed new Item 402(x)(i), including registrants' policies and practices regarding the timing of these awards and whether the board of directors or compensation committee takes material nonpublic information into account when making award grants, is appropriate and would substantially address the concerns discussed in the release without the problems inherent in proposed Item 402(x)(ii).

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We appreciate the Commission's consideration of the foregoing comments.

Very truly yours,

Committee on Securities Law of the Business Law Section of the Maryland State Bar Association

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