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April 1, 2022

Submitted by SEC Webform (http://www.sec.gov/rules/submitcomments.htm)

Vanessa Countryman
Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

RE: File No. S7-20-21: Rule 10b5-1 and Insider Trading

Dear Ms. Countryman:

On behalf of the North American Securities Administrators Association, Inc. ("NASAA"),[1] I am writing in response to U.S. Securities and Exchange Commission ("SEC" or the "Commission") Release No. 33-11013, *Rule 10b5-1 and Insider Trading* (the "Proposal").[2] NASAA generally supports the Proposal and believes it is a meaningful enhancement of the insider trading laws. However, certain further changes are necessary for these amendments to reach their potential. We offer the following comments for the Commission's consideration.

I. Rule 10b5-1 Has Strayed from Its Original Intent.

Investor trust and confidence are key to maintaining fair, orderly, and efficient markets for all participants. The securities laws prohibit insider trading because, among other things, it undermines investor confidence in the fairness and integrity of our securities markets.[3]

In 2000, the Commission adopted Rule 10b5-1 under the Securities Exchange Act of 1934 (the "Exchange Act") to provide greater clarity to market participants as to the circumstances in which a trade will be deemed to have been made on the basis of material nonpublic information

[1] Organized in 1919, NASAA is the oldest international organization devoted to investor protection. NASAA's membership consists of the securities administrators in the 50 states, the District of Columbia, Canada, Mexico, Puerto Rico, and the U.S. Virgin Islands. NASAA is the voice of securities agencies responsible for grass-roots investor protection and efficient capital formation.

[2] The Proposal is available at https://www.sec.gov/rules/proposed/2022/33-11013.pdf.

[3] *See, e.g.*, Final Rule, *Selective Disclosure and Insider Trading*, SEC Rel. No. 33-7881 (the "2000 Adopting Release"), 65 FR 51715, 51727 (Aug. 24, 2000) ("[T]he fundamental unfairness of insider trading harms not only individual investors but also the very foundations of our markets, by undermining investor confidence in the integrity of the markets.").

("MNPI") in violation of Exchange Act Section 10(b) and Rule 10b-5 thereunder.[4] Rule 10b5-1 also provides an affirmative defense to insider trading liability for issuers and corporate insiders who, in good faith, make prearranged plans, contracts, or instructions to buy or sell securities in the future ("Trading Arrangements") and who are not in possession of MNPI when establishing the Trading Arrangement.[5] This safe harbor was intended to preserve the ability of executives and employees to trade for legitimate purposes[6] – *e.g.*, to pay expenses, diversify investments, or generate cash – where it is "clear that [MNPI] was not a factor in the decision to trade."[7]

Although simple in concept and clear in its intent, Rule 10b5-1 has proven difficult to enforce. Today, it is comparatively easy for corporate insiders to manipulate the rule in order to engage in conduct that might otherwise appear to be insider trading by, for example, selectively modifying or canceling unfavorable trades prior to execution, or commencing trading shortly after adopting or modifying a Trading Arrangement. Such activity evades the goals of the rule and undermines public trust in the fairness and integrity of the markets.

Various stakeholders, including NASAA and the SEC Investor Advisory Committee ("IAC"), have raised these and other concerns over the years.[8] We are pleased that the Commission has undertaken to address the shortcomings in Rule 10b5-1 and provide greater transparency to investors.

II. All Trading Arrangements Should Be Subject to the Proposed Cooling-Off Periods.

The Proposal would require all Trading Arrangements entered into by issuers, officers, and directors to include a mandatory cooling-off period of 120 days for officers and directors, and 30 days for issuers, before trading can commence under the Trading Arrangement.[9] Any modification

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4 *Id.*

5 17 CFR 240.10b5-1(c)(1).

6 Recommendations of the Investor Advisory Committee Regarding Rule 10b5-1 Plans (Sept. 9, 2021) at 2 ("IAC Recommendations"), *available at* https://www.sec.gov/spotlight/investor-advisory-committee-2012/20210916-10b5-1-recommendation.pdf.

7 2000 Adopting Release, 65 FR at 51716. *See also* Proposal at 6-7.

8 *See* NASAA Legislative Agenda for the 117th Congress (Mar. 2021) at 14, *available at* https://www.nasaa.org/wp-content/uploads/2021/10/NASAA-Legislative-Agenda-for-117th-Congress.pdf; NASAA, Letter to Chair Maxine Waters and Ranking Member Patrick McHenry, House Comm'ee on Fin. Servs. (Mar. 8, 2021), *available at* https://www.nasaa.org/wp-content/uploads/2021/03/NASAA-Letter-to-Chair-Waters-and-Ranking-Member-McHenry-Re-1528-3.8.21-F-PDF.pdf; NASAA, Letter to Chair Maxine Waters and Ranking Member Patrick McHenry, House Comm'ee on Fin. Servs. (Jan. 23, 2019), *available at* https://www.nasaa.org/wp-content/uploads/2019/05/NASAA-Letter-to-Chair-Waters-and-Ranking-Member-McHenry-Re-H.R.624-January-23-2019.pdf; IAC Recommendations, *supra* note 6. *See also* Proposal at 7-8 (discussing concerns raised by various stakeholders and observers).

9 Proposal at 14.

of a Trading Arrangement would constitute termination of that Trading Arrangement and adoption of a new one, subject to a new cooling-off period.[10]

NASAA strongly supports the imposition of mandatory cooling-off periods. These measures would strengthen compliance with the rule's intent, help to encourage investor confidence in the markets, and ensure a more level playing field for investors. The proposed 120-day period would help to reduce the ability of insiders to misuse information from within the safe harbor by preventing trades from occurring under a recently-adopted or recently-modified Trading Arrangement until after the market has been given equal access to the vital information found in the company's quarterly earnings announcements. Because modification of a Trading Arrangement would reset the cooling-off period, this requirement would also disincentivize selective termination or cancelation of trades on the basis of MNPI.

However, the proposed 120-day cooling-off period should apply to all Trading Arrangements, not only those adopted by officers and directors. While it may be true that officers and directors are more likely than other employees to be aware of MNPI by virtue of their places within a company, other corporate insiders and lower-level employees can also have access to such information. All traders seeking to rely on the affirmative defense provided under Rule 10b5-1(c)(1) should be held to the same cooling-off standard.

Similarly, issuers should be subject to the same 120-day cooling-off period as other traders. The vast majority of the commentary cited in the Proposal supports a cooling-off period of four to six months without any distinction between issuers and non-issuers,[11] and this position has also been endorsed by both former Commission Chair Jay Clayton and Commissioner Caroline Crenshaw, among others.[12] Only one source cited in the Proposal refers to a 30-day cooling-off period for issuers, positing that "[w]hile not cast in stone, a waiting period of 30 days *or more* is a reasonable timeframe."[13] The proposed 30-day cooling-off period for issuers would do little to

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[10] *See id.* at 9 n.23, 143.

[11] *See id.* at 15 n.34 (citing IAC Recommendations for recommendation of four months); David F. Larcker, *et al.*, *Gaming the System: Three "Red Flags" of Potential 10b5-1 Abuse*, Stan. Closer Look Series, Corp. Governance Res. Series ("Gaming the System") (Jan. 2021) at 3, *available at* https://www.gsb.stanford.edu/sites/default/files/publication-pdf/cgri-closer-look-88-gaming-the-system.pdf (recommending four to six months); Client Alert, Paul, Hastings, Janofsky & Walker LLP, *"SEC Targets 10b5-1 Plans,"* (Dec. 2007) at 2, *available at* https://www.gsb.stanford.edu/sites/default/files/publication-pdf/cgri-closer-look-88-gaming-the-system.pdf (recommending one fiscal quarter); Letter from Sen. Elizabeth Warren et al. (Feb. 10, 2021), *available at* https://www.warren.senate.gov/imo/media/doc/02.10.2021%20Letter%20from%20Senators%20Warren,%20Brown,%20and%20Van%20Hollen%20to%20Acting%20Chair%20Lee.pdf (recommending four to six months).

[12] *See* Alan Jagolinzer *et al.*, *How the SEC can and should fix insider trading rules*, The Hill (Dec. 17, 2020), *available at* https://thehill.com/opinion/finance/530668-how-the-sec-can-and-should-fix-insider-trading-rules/ (noting that former Chair "Clayton suggested a four-to-six-month cooling off period"); Caroline Crenshaw and Daniel Taylor, *Insider Trading Loopholes Need to Be Closed*, BloombergQuint (Mar. 15, 2021), *available at* https://www.bloombergquint.com/gadfly/insider-trading-loopholes-need-to-be-closed (calling for a cooling-off period of four to six months).

[13] *See* Robert H. Friedman *et al.*, *Navigating Public Company Equity Buybacks*, Insights: Corporate and Securities Law Advisor, Vol. 25, No. 12 (Dec. 2011) at 5, *available at*

address the concerns underlying the imposition of a cooling-off period. The Proposal cites the "concern that issuers may conduct stock buybacks while aware of [MNPI]," such as when "executives of an issuer [] are aware of materially positive but undisclosed developments [and] cause the issuer to buy its stock from current shareholders who are unaware of those developments."[14] The proposed 30-day period is likely to prove too short a time period to ensure that current shareholders are informed of the relevant developments prior to such a buyback campaign, but a 120-day cooling-off period would achieve this in most instances.

The Proposal asks whether there should be an exception from the cooling-off period for *de minimis* changes to any Trading Arrangement and what the parameters should be.[15] The Proposal does not define "*de minimis*" in this context, but we believe that a *de minimis* exception is unnecessary and could undermine the intent of the rule by creating unwarranted loopholes. In particular, changes that affect the timing, size, price, order type, or other transactional details for any trades under a Trading Arrangement should not be excused from compliance with the rule.

III. An Affirmative Defense Should Be Unavailable under Rule 10b5-1 for Both Overlapping and Single-Trade Trading Arrangements.

The Proposal would eliminate the affirmative defense under Rule 10b5-1(c)(1) for a person who has or subsequently establishes additional Trading Arrangements for open market purchases or sales of the same class of securities.[16] This restriction would address a concern long held by investors, investor advocates, and regulators that overlapping Trading Arrangements have been used to circumvent the spirit of the rule by selectively canceling unfavorable trades and allowing favorable trades to be executed.[17] The existence of multiple overlapping Trading Arrangements naturally raises legitimate questions about whether corporate insiders are acting in good faith or are acting contrary to the spirit of the rule. This restriction should have little impact on legitimate buying, selling, and planning activities because traders can incorporate multiple strategies in a single Trading Arrangement. As such, NASAA supports the proposed restriction on overlapping Trading Arrangements.

However, we believe that this provision would be far more effective if it is expanded to limit the affirmative defense to one Trading Arrangement for all of the issuer's equity securities and equity derivatives, such as warrants and options. Although the market is sometimes unpredictable, MNPI is likely to affect all equity in the same basic way: good news will increase

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https://www.olshanlaw.com/assets/htmldocuments/Insights_v25n12_Dec11.pdf (emphasis added); Proposal at 15 n.34 (citing same).

[14] Proposal at 16.

[15] *Id.* at 17, Question 7.

[16] *Id.* at 21.

[17] *See, e.g.*, Rulemaking Petition Regarding Rule 10b5-1 Trading Plans, Council of Institutional Investors ("CII Rulemaking Petition") (Dec. 28, 2012), *available at* https://www.sec.gov/rules/petitions/2013/petn4-658.pdf; IAC Recommendations at 2-4; NASAA Legislative Agenda for the 117th Congress, at 14 (Mar. 8, 2021), *available at* https://www.nasaa.org/wp-content/uploads/2021/10/NASAA-Legislative-Agenda-for-117th-Congress.pdf; NASAA, Letter to Chair Maxine Waters and Ranking Member Patrick McHenry (Jan. 23, 2019), *supra* note 8.

value and bad news will decrease it. As such, there seems to be little practical need to have different Trading Arrangements to cover different "classes" of equity. Further, limiting the restriction to the "same class of securities," as proposed, could ultimately encourage traders to simulate the current status quo using separate Trading Arrangements for common and preferred stock, or stock and options. This dynamic has already been observed with Rule 10b5-1. The rule currently denies the safe harbor to a person who has "entered into or altered a corresponding or hedging transaction or position with respect to those securities."[18] This requirement was designed to prevent schemes to exploit MNPI by setting up hedged trading programs, and then canceling the unfavorable side of the hedge and allowing execution of the favorable side.[19] However, the Proposal recognizes that overlapping Trading Arrangements "can be used to simulate this kind of impermissible hedging" under Rule 10b5-1.[20] The Commission should expand the restriction to close this potential loophole.

The Proposal does not go far enough with regard to single-trade Trading Arrangements. Under the Proposal, the affirmative defense would be available for one single-trade Trading Arrangement during any 12-month period.[21] This is contrary to the intent that the affirmative defense in Rule 10b5-1(c)(1) apply where it is "clear that [MNPI] was not a factor in the decision to trade."[22] In a recent academic study, researchers reviewed data on trading in over 20,000 Trading Arrangements and concluded, in part, that single-trade Trading Arrangements are "associated with opportunistic planned trading under Rule 10b5-1" and that these trades are "consistently loss-avoiding *regardless of cooling-off period*."[23] It is not "clear" that MNPI is not a factor in such Trading Arrangements. The data suggests the opposite; namely, that MNPI *is* a factor in many single-trade Trading Arrangements.

It is also not apparent that allowing a safe harbor for one single-trade Trading Arrangement per 12 months would confer a meaningful benefit. The Proposal cites the need to "address one-time liquidity needs,"[24] but does not explain why these liquidity needs cannot be accounted for in the preparation of a longer-term Trading Arrangement. Given the prevalence of opportunistic and otherwise-problematic trades in single-trade Trading Arrangements as noted in the study cited above, these Trading Arrangements should not be included in the Rule 10b5-1(c)(1) affirmative defense.

The issues observed with overlapping and single-trade Trading Arrangements suggest that, even though Trading Arrangements may be adopted in good faith, insiders have taken advantage

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[18] 17 CFR 240.10b5-1(c)(1)(i)(C).

[19] Proposed Rule, *Selective Disclosure and Insider Trading*, SEC Rel. No. 33-7787, 64 FR 72590, 72602 (Dec. 28, 1999).

[20] Proposal at 21.

[21] *Id.* at 22.

[22] 2000 Adopting Release, 65 FR at 51716.

[23] Gaming the System, *supra* note 11 (emphasis original).

[24] Proposal at 22.

of the safety afforded by the affirmative defense to use MNPI in a way that is not consistent with the intent of the rule. The Proposal would enhance the rule to expressly require that Trading Arrangements continue to be operated in good faith after adoption.[25] NASAA supports this amendment. The concept that a Trading Arrangement be entered into in good faith has been a part of the rule since it was adopted,[26] so it should pose a minimal burden to apply it to the continued operation of a Trading Arrangement.

IV. The Proposed Issuer Disclosure Requirements Would Meaningfully Enhance Transparency for Investors and Regulators about Trading Arrangements and the Potential for Misuse of MNPI.

Currently, information about insider trading controls and Trading Arrangements is maintained by issuers and corporate insiders. As a practical matter, "[t]his creates a black box around [Trading Arrangements] that effectively shields insiders from investor scrutiny and possible enforcement action in cases of potential abuse."[27] The Proposal would address these concerns by adding new Items 408(a) and (b) to Regulation S-K. Item 408(a) would require issuers to disclose, quarterly, whether the issuer or any of its officers or directors adopted or terminated[28] any Trading Arrangements during the most recent quarter and, if so, the date of adoption or termination, the duration, the aggregate amount of securities to be purchased or sold, and the name and title of the officer or director (if applicable).[29] Item 408(b) would require issuers to disclose, annually, whether they have adopted insider trading policies and procedures governing the purchase, sale, and other disposition of the issuer's securities by directors, officers, and employees, or the issuer itself.[30] If so, the issuer would be required to disclose its policies and procedures; if not, the issuer would be required to explain why it has not done so.[31]

We believe that the proposed company disclosures would improve transparency for investors, particularly in the area of the issuer's policies and procedures. This is a potentially critical data point for investors because the misuse of MNPI by corporate insiders (to say nothing of the issuer itself) can have devastating effects on the issuer's prospects, and thus the potential success of the investment. Greater transparency would also help to limit incentives for insiders to misuse MNPI for unfair advantages, and potentially incentivize corporate boards and management teams to scrutinize the company's "corporate hygiene" regarding MNPI and insider trading. As

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25 *See id.* at 24.

26 *See* 17 CFR 240.10b5-1(c)(1)(ii).

27 IAC Recommendations at 5.

28 Similar to the proposed amendments to Rule 10b5-1, any modification of a trading arrangement would be considered termination of that Trading Arrangement and adoption of a new one. Proposal at 27 n.50, 138-39.

29 Proposal at 27-28.

30 *Id.* at 31.

31 *Id.*

such, NASAA strongly supports the proposed issuer disclosures. However, we offer two suggestions that we believe would further enhance transparency and benefit investors.

First, issuers should be required to disclose the same information about Trading Arrangements adopted or terminated by all employees who do so, not only the issuer and its officers and directors. As discussed above, any employee could potentially have access to MNPI. If the circumstances warrant the adoption of a Trading Arrangement, that Trading Arrangement should be placed on equal footing with those established by officers and directors.

Second, issuers should be required to disclose additional details about Trading Arrangements adopted or terminated during the previous quarter; namely, the terms of any overlapping Trading Arrangement that existed at the time of adoption or modification, and the total number and frequency of planned transactions under the Trading Arrangement. This additional information will enable investors to assess the extent to which the issuer or corporate insiders are using Trading Arrangements in ways that are correlated with opportunistic trading, such as the use of overlapping or single-trade Trading Arrangements.

V. NASAA Supports the Proposed Issuer Disclosures Regarding the Timing of Option Grants and Similar Equity Compensation.

In addition to the proposed disclosures regarding issuers' use of and controls around Trading Arrangements, the Proposal would enhance issuers' existing disclosure obligations regarding grants of options and similar equity compensation close in time to the release of MNPI. Specifically, the Proposal would require annual tabular disclosure of all option awards granted within 14 days before or after certain public disclosures of MNPI, including the number of underlying securities, the date of the grant, the grant date fair value, and the option's exercise price, as well as the market price of the underlying securities on the trading days immediately before and after the disclosure of MNPI.[32]

The proposed disclosures are designed the provide shareholders with valuable information about potential so-called spring-loading and bullet-dodging tactics by corporate insiders. Although spring-loading and bullet-dodging option grants are arguably not as egregious as the practice of backdating, these practices are controversial for good reason. Spring-loading and bullet-dodging option grants can look a lot like insider trading to investors and other observers, which undermines the perceived fairness and integrity of the markets. In some circumstances there may appear to be little or no material difference between these practices and insider trading. To the extent that the spring-loaded options themselves are effectively "in the money" before the market knows this to be the case, the practice also raises questions about whether the issuer and corporate insiders are being honest about their executive compensation practices.[33]

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[32] *See id.* at 40-41.

[33] For example, in recent accounting guidance, the SEC staff clarifies that when measuring the fair value of equity compensation, "companies should carefully consider whether an adjustment to the observable market price is required, for example, when share-based payments arrangements are entered into in contemplation of or shortly before a planned release of material non-public information, and such information is expected to result in a material

Shareholders need and deserve to have information about these practices as they make investment decisions and consider their votes on various proposals, including executive compensation and the election of directors. As such, NASAA supports the proposed requirement to disclose this information annually on Form 10-K and in the company's proxy statement.[34] To the extent that these disclosure requirements might deter or discourage the use of spring-loaded and bullet-dodging option grants because of concern that the market or existing shareholders will react negatively, we view this as a positive secondary effect and a strong argument in favor of the materiality of this information to investors.

NASAA appreciates and supports the decision not to exempt smaller reporting companies and emerging growth companies from these important disclosures. As the Proposal notes, the information provided by these disclosures "is material to all investors, and no less relevant to shareholders of a smaller reporting company or an EGC."[35]

VI. Conclusion

NASAA is pleased to see that the Commission plans to amend Rule 10b5-1 to better align the rule with its original intent. For the reasons discussed above, NASAA broadly supports the Proposal. However, we believe that there are areas for improvement. Thank you for considering these views. NASAA looks forward to continuing to work with the Commission in the shared mission to protect investors. Should you have questions, please contact either the undersigned or NASAA's General Counsel, Vince Martinez, at (202) 737-0900.

Sincerely,

Melanie Senter Lubin
NASAA President
Securities Commissioner for the
State of Maryland

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increase in share price. The staff believes that non-routine spring-loaded grants merit particular scrutiny by those charged with compensation and financial reporting governance." Sec. & Exch. Comm'n, Staff Accounting Bulletin No. 120 (Nov. 24, 2021), *available at* https://www.sec.gov/oca/staff-accounting-bulletin-120.

[34] *See* Proposal at 42.

[35] *Id.* at 43.