Statement by Granville Martin, General Counsel, Society for Corporate Governance

before

the U.S. House of Representatives Committee on Financial Services

on

Insider Trading and Stock Option Grants: An Examination of Corporate Integrity in the Covid-19 Pandemic

Chairman Sherman, Ranking Member Huizenga and Members of the Committee, thank you for the opportunity to testify today. I am Granville Martin, General Counsel of the Society for Corporate Governance. Prior to my tenure at the Society, I was a Managing Director in Sustainable Finance at JPMorgan Chase where I worked to manage environmental and social risk on behalf of the bank and assisted clients in improving the governance of those same risks.

Founded in 1946, the Society is a professional membership association of approximately 3,500 corporate and assistant secretaries, in-house counsel, outside counsel, and other governance professionals who serve approximately 1,700 entities, including approximately 1,000 public companies of almost every size and industry. Society members are responsible for supporting the work of corporate boards of directors and the executive managements of their companies on corporate governance and disclosure matters.

The Society's mission is to educate corporate governance practitioners on core and emerging governance issues. We have traditionally focused on securities and state corporate law compliance and disclosure and in the last several years have broadened our perspective of governance to also include environmental and social issues, risks and disclosures (i.e. ESG). Diversity, climate change and human capital management are among the ESG issues upon which investors have sought greater disclosure and that public companies increasingly provide. ESG is just one example of how the relevance and importance of corporate governance has increased in the last decade.

The topic of today's hearing—the regulation of insider trading—is a longstanding issue confronting the Society's public company members. At the outset, let me state clearly that the Society and its public company members support a rigorous framework of insider trading regulation, compliance training, and effective enforcement. Ensuring America's capital markets retain their reputation for transparency and fairness that undergirds investor confidence is in the interests of all public companies. A market where insiders can benefit from material non-public information (MNPI) at the expense of other investors is wrong, and the Society supports the laws, regulations and enforcement mechanisms intended to prevent and punish such conduct.

It's also relevant that the legal framework governing insider trading for public companies encourages them to adopt policies and procedures intended to prevent their executives from becoming embroiled in allegations of insider trading. Most public companies have adopted insider trading policies that govern trading of their Company's securities as well as securities of other publicly-traded companies. Common features of such policies include a prohibition of trading at any time while in possession of MNPI, a dedicated brokerage firm that administers the accounts where company equity grants and stock are held, a pre-clearance procedure of transactions by in-house legal departments, imposition of trading blackout periods in advance of earnings releases or in the event of significant corporate events--such as an acquisition or leadership change--and limitations on the adoption of 10b5-1 plans.

It is worth noting that company-imposed blackout periods restricting executives from buying or selling stock generally begin several weeks prior to the end of the fiscal quarter and last until one or two days after the publication of the company's applicable quarterly earnings materials. As a result, company officers and directors typically will have up to four open windows per year with each window lasting just a few weeks. In addition, a trading window may be closed early upon the development of new material information such as an acquisition or leadership change. As a result, the time that buying and selling may actually occur is quite limited.

Section 10(b) of the Securities Exchange Act of 1934 (Exchange Act) and the associated Rule 10b-5 prohibit the employment of manipulative and deceptive devices in the trading of securities. Rule 10b5-1 states that the manipulative and deceptive devices prohibited under Section 10(b) and Rule 10b-5 include purchases and sales of securities made "on the basis of" MNPI about a security or issuer in breach of a duty of trust or confidence that is owed to the issuer of that security or the shareholders of that issuer, or to any other person who is the source of the MNPI. Furthermore, Rule 10b5-1 specifies that a purchase or sale of a security is made on the basis of MNPI when the person making the purchase or sale was "aware" of MNPI at the time the purchase or sale was made. Rule 10b5-1 also provides an affirmative defense to Section 10(b) insider trading allegations when such trades are made pursuant to a preexisting, written trading plan that complies with the rule.

Rule 10b5-1 allows corporate executives to adopt a plan, at a time when they are not in possession of MNPI, to make prearranged trades at specified prices or dates in the future. As noted above, a properly adopted 10b5-1 plan provides an executive "a safe harbor" to proceed with prearranged trades without facing charges of insider trading. The rule is intended to give executives an opportunity to transact in company stock —to pay their kids' college tuition, for example—in a structured manner consistent with the insider trading legal framework. The rule's affirmative defense or "safe harbor" is available only if a 10b5-1 plan was entered into in good faith and not as part of a scheme to evade Section 10(b)'s and Rule 10b-5's insider-trading prohibition.

To be effective, 10b5-1 plans must satisfy certain requirements. Among other things, a 10b5-1 plan must:

- Be established in good faith when the participant was not aware of inside information;
- Specify the number of securities to be traded and the price at which the securities are to be traded, or include a formula for making such determination; and
- Prohibit the participant from later exercising any influence over any person who exercises discretion as to how, when, or whether to effect the trades.

Rule 10b5-1 provides specific guidance in the insider trading realm, but it does not operate in a vacuum and co-exists with other securities laws, which remain applicable. For example, Rule 10b5-1 does not alter the elements of a case under Rule 10b-5/Section 10(b) (e.g., scienter is still required). Additionally, transactions pursuant to a Rule 10b5-1 plan must still comply with (1) the volume limitations of Rule 144 (if shares are not otherwise freely tradable and Rule 144 applies), (2) short swing profit rules and filings of ownership forms under Section 16(a) of the Exchange Act (i.e., filing a Form 4 in connection with each transaction), and (3) filing Schedules 13D or 13G where appropriate.

In addition, many companies impose additional restrictions on the adoption and use of 10b5-1 plans by their executives, if the company allows these plans at all. For example, a 2015 survey conducted by the Society of its public company members showed that most surveyed companies only permit a 10b5-1 plan to be adopted when their insider trading window is open. That is, these companies do not allow plans to be entered into during blackout periods, even if the insider is not in possession of MNPI. Similarly, 85% of 235 companies surveyed responded that they formally review and approve all of their company's 10b5-1 plans.

The Section 10(b) and Rule 10b5-1 prohibition on insiders' trading when aware of MNPI, along with the related disclosure obligations and established company practices noted above, deter and punish illegal conduct yet allow executives to transparently trade their companies' securities for the purposes of diversification or paying for significant life events (i.e. home purchase/college tuition) . To be sure—as with any area of the law—transgressions may occur. And when they do, the SEC—and the U.S. Department of Justice, if appropriate—should vigorously and fairly investigate and prosecute wrongdoing. Having said that, the Society believes that existing laws, regulations and the enforcement regime provide a comprehensive legal framework.

Like so many other aspects of our lives, COVID-19 presented new and abrupt challenges to public companies, including related to insider trading law compliance. As companies grappled with the implications of the pandemic in their disclosures and their internal policies and procedures, SEC Division of Enforcement issued a statement emphasizing the "importance of maintaining market integrity and following corporate controls and procedures."[1] In addition, SEC Chairman Jay Clayton and Division of Corporation Finance Director Bill Hinman issued a statement[2] urging companies to "provide as much information as is practicable regarding their current financial and operating status, as well as their future operational and financial planning" and noting that "[d]isclosure…is fundamental to furthering each aspect of our mission."

Based on our review of Society members' disclosures, we believe public companies responded robustly. COVID-related disclosure has been widespread and has covered a wide range of topics. In addition, many public companies re-assessed their insider trading policy compliance program, including whether their internal procedures were able to identify all of the executives who were now possibly in possession of COVID-related MNPI, whereas pre-pandemic such concerns regarding procurement, supply chain and operational executives were minimal. The Society provided educational resources to public company members to assist members in their compliance initiatives, and they responded accordingly.

[1] https://www.sec.gov/news/public-statement/statement-enforcement-co-directors-market-integrity

[2] https://www.sec.gov/news/public-statement/statement-clayton-hinman

In general, the Society does not have a position on the appropriateness of the amount or structure of executive compensation. Having said that, we would observe that the use of stock options by start-ups and other early stage companies is common and, from the perspective of the management of such companies, essential. These companies' use of stock options for compensation is a key driver in their ability to attract and retain the talent necessary to foster innovation and commercialization of new products and services. Ownership of stock by employees also more closely aligns their interests with the interests of company shareholders, which is rightly a high priority for the investor community.

While the Society supports required disclosure of executive compensation arrangements, we note that boards of directors and their compensation committees are best positioned to decide on the appropriateness of such option grants and that investors express their view of the appropriateness of compensation through required "say on pay" votes that occur in many cases annually. When significant numbers of investors express concern with a particular pay package, boards and management regularly take action to assuage those concerns even though such "say on pay" votes are precatory. Further regulation in this area is unnecessary. Transparency and fairness exist under the existing regulatory framework.

Similarly, H.R. 4335, the 8-K Trading Gap of 2019, which "would direct the SEC to issue a rule requiring public companies to put in place policies and procedures that are reasonably designed to prohibit officers and directors from trading company stock after the company has determined that a significant corporate event has occurred, and before the company has filed a Form 8-K disclosing such event" is unnecessary, in our view, given that Section 10(b) and Rule 10b-5 already prohibit trading by officers and directors if the undisclosed "significant event" is material. While we are heartened by the bipartisan comity engendered by this bill, we would note that H.R. 4335 makes conduct that is already prohibited illegal.

We believe the regulation of insider trading has been subject to some confusion. I would argue that the 8-K Trading Gap bill is an example. Having said that, the SEC study mandated by H.R. 624 could contribute to a common and well-founded understanding of 10b5-1 plans, their structure and effect, and whether any regulatory changes are warranted. The Society supports the enactment of H.R. 624.

Thanks to the Committee for inviting me to testify, and I'd be happy to respond to any questions.