Pearl Meyer

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# The Impact on Biotech: New Insider Trading and Related Disclosure Rules

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On December 15, 2022, the SEC adopted final changes to new insider trading rules. Much of the external focus has been on the implications for 10b5-1 trading plans, but the rules also added other disclosure requirements that may warrant more significant discussion in biotech than in other sectors of the marketplace. The new disclosure requirements include 1) addressing the extent to which material nonpublic information (MNPI) is considered in setting grant dates for stock option awards, and 2) an additional compensation table that is only applicable to stock option-granting companies in certain instances.

> Rule 10b5-1 allows insiders to sell company stock by setting up a predetermined plan that specifies in advance the share price, amount, and transaction date. The insider selling the stock and the broker carrying out the transaction must certify that they are not aware of any material nonpublic information (MNPI).

Biotech will likely be more heavily impacted for two primary reasons:

- While stock option usage in the broader market has declined, stock options remain the primary equity vehicle in biotech, particularly amongst development-stage companies and within the executive ranks; and
- The cadence of MNPI is highly unpredictable in biotech as scientific, clinical, and regulatory updates/events can occur throughout the year, and sometimes without much warning. Outside of biotech, the cycle of MNPI is more predictable and often limited to the quarterly financial reporting cadence.

## What new disclosures are required?

The rule changes provide for additional disclosure requirements around insider trading, including:

- Annual disclosure of insider trading policies;
- Quarterly disclosure of Rule 10b5-1 plans;
- Additional check-the-box information on Forms 4 and 5;
- Annual disclosure of stock option grant policies—specifically, narrative disclosure in the Compensation Discussion & Analysis section (CD&A) of the proxy statement describing the policy or practice of the board or committee of its consideration of MNPI in determining stock option grant dates; and
- A new compensation table if stock option awards are granted within four days prior to or one day after the release of MNPI.

It is important that biotech companies consider the last two items in particular, ahead of future annual awards as well new-hire or special awards. The items address two practices that the SEC is targeting where option recipients can benefit significantly from the timing of equity awards: "spring-loading" and "bullet-dodging."

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| Spring-loading | Granting in advance of the release of positive MNPI—the strike price is set before an expected runup in the stock price upon the release of the information |
| Bullet-dodging | Delaying grants until after the release of negative MNPI—the company expects a decline in the stock price and by delaying, options are struck at the lower price after the decline, avoiding a situation where the awards nearly immediately go —potentially significantly—underwater |

## What will the new stock option grant tabular disclosure include?

New Item 402(x) of Reg S-K requires a new table for stock option awards to NEOs within four days prior to or one day after the release of MNPI. These will highlight potential instances of spring-loading or bullet-dodging and specifically value the benefit to the individuals. For the purposes of determining whether this additional table is required, MNPI triggering events include filing of a periodic report (e.g., 10-K or 10-Q) and filing of a current report with MNPI (e.g., 8-K).

- For each NEO, the table must include on an award-by-award basis:
- The date of grant;
- The number of stock options;
- The strike price;
- The fair market value of the award at grant; and
- The percentage change in the close price from the trading day prior to the release of MNPI to close price one day thereafter.

Companies will likely attempt to avoid this supplemental disclosure, which shareholders and proxy advisory firms are going to be keen to review and analyze. As such, setting company grant date policies or practices will be of increased importance.

## What are the potential implications of the varied market practices?

There is a wide range in practice as to how companies currently select their equity award grant dates. With the introduction of the rules, some companies will want to determine whether modifying their policies or practices or formalizing new ones is appropriate.

One practice is to hardwire grant dates in advance through a formal approved equity grant policy. The fixed dates may be a specific day of the month or next month following the date of approval, or a set number of days after quarterly earnings releases. These companies will be able to very clearly disclose that they do not consider the possession or release of MNPI in granting awards. This provides a degree of "protection" from a governance perspective but could trigger the supplemental option table in certain instances.

Others have formal approved equity grant policies that don't fix the specific dates in advance, but rather allow the plan administrator some flexibility in setting grant dates. These policies often contain provisions specifying that the administrator will not deliberately accelerate or delay the release of MNPI in an effort to benefit recipients. By preserving flexibility, though, these companies may be able to avoid the supplemental option table by setting award dates outside the triggering window. The new rules will require these companies to provide more fulsome disclosure about the process of selecting grant dates in future proxy statements.

The last group operates without a formal policy and typically settles into a practice of setting grant dates on a fixed cadence, for example, upon approval of awards at the Q1 board meeting. There has been a benefit to having a set cadence for employees in terms of compensation and expectations, but also in having precedent in order to defend against any potential external critiques. For some, though, the current practice will land them right in the triggering window for the supplemental table. They may determine to further evolve the practice to be outside the window but will need to thoroughly explain in their CD&A how the possession or release of MNPI dictates the option grant date.

## So what now?

Companies cannot always predict in advance when they will be in possession of MNPI. In determining the right approach, compensation committees should discuss where they are willing to take on increased risk. Is it better to grant options without consideration of MNPI and potentially have to disclose the new table? Or is it better to consider MNPI and setting a policy or practice that avoids triggering the new table?

Selecting a more rigid approach will provide protection in upside scenarios but could lead to undesirable situations in downside scenarios. Alternatively, maintaining total flexibility would leave the door open for external criticism and pushback. While there are pros and cons to each position, the important point is for compensation committees to proactively debate and weigh the issues as they pertain to their current practice and/or to any proposed change—and then prepare accordingly.

## About the Author

Matt Molberger is a managing director at Pearl Meyer. He consults primarily with companies in the life sciences and technology sectors. Matt works with clients to develop comprehensive executive compensation programs that support long-term business objectives. He specializes in pay benchmarking, incentive plan design, pay-for-performance alignment, security arrangements, and CD&A disclosure. Matt's client experience ranges from pre-IPO planning to supporting Fortune 500 companies throughout the annual compensation cycle.

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