

September 26, 2022

# Recent SEC Insider Trading Action Provides Key Insights Into the Future of Rule 10b5-1

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## The SEC's Cease-and-Desist Order Actuates Proposed Amendments to Rule 10b5-1.

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### SUMMARY

On September 21, 2022, the Securities and Exchange Commission found that Cheetah Mobile Inc.'s Chief Executive Officer, Sheng Fu, and its former President, Ming Xu, committed insider trading in relation to securities they sold under a joint "10b5-1 plan." In addition to paying civil penalties, they also agreed in a Cease-and-Desist Order to various undertakings, which notably includes Fu adhering to a 120-day cooling-off period for his future 10b5-1 plans. The undertakings in the Order reflect the SEC's recently proposed, but not yet adopted, amendments to Rule 10b5-1, perhaps signaling the next steps of the SEC and best-practices of the industry moving forward.

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### BACKGROUND

Rule 10b5-1 of the Securities Exchange Act of 1934<sup>1</sup> was adopted by the SEC in 2000 to clarify insider trading liability regarding the "use" or "knowing possession" of material nonpublic information ("MNPI").<sup>2</sup> The rule sets forth two affirmative defenses to insider trading, one of which is the adoption of a 10b5-1 trading plan.<sup>3</sup> These plans allow insiders to engage in securities transactions regardless of whether they are aware of MNPI at the time of the trade, so long as the insider is not aware of MNPI when the plan is implemented.<sup>4</sup>

Rule 10b5-1 has come under heightened scrutiny from commentators, including members of Congress.<sup>5</sup> The SEC has thus expressed an energized interest in reforming Rule 10b5-1. In 2020, former SEC Chair Jay Clayton urged companies to implement mandatory waiting periods after any adoption, modification, or

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termination of a 10b5-1 trading plan.<sup>6</sup> In 2021, SEC Chair Gary Gensler asked the staff to consider requiring a mandatory 30-day cooling-off period (discussed [here](#)).<sup>7</sup> After similar but more extensive recommendations from the SEC's Investor Advisory Committee (discussed [here](#)),<sup>8</sup> the SEC recently proposed amendments to Rule 10b5-1 (discussed [here](#)). These include, *inter alia*, (i) a 120-day cooling-off period for officers and directors (and a 30-day cooling-off period for issuers) after any adoption of, or modification to, a 10b5-1 plan before any securities transactions under the plan, and (ii) an exclusion of Rule 10b5-1's affirmative defense for multiple 10b5-1 trading plans in the same class of securities.<sup>9</sup>

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### ENFORCEMENT ACTION AND CEASE-AND-DESIST ORDER

While the proposed amendments have not yet been adopted by the agency, they have been put on full display with the SEC's recent enforcement action against two Cheetah Mobile employees. Cheetah Mobile is an application developer that earned up to one-third of its revenue from a single advertising partner.<sup>10</sup> According to the SEC's Order, in the summer of 2015, Cheetah Mobile was made aware that the advertising partner was going to change its algorithm that calculated payments for advertisements.<sup>11</sup> As a result, Cheetah Mobile's revenue from the advertising partner declined in the fourth quarter of 2015 and first quarter of 2016.<sup>12</sup> In May 2016, when Cheetah Mobile disclosed this revenue decline and advised that it would not meet its revenue and earnings guidance for 2016 ("May Announcement"), the price of the company's American Depository Shares ("ADS") dropped around 18% by the end of the day.<sup>13</sup>

The Order found that CEO Fu and former President Xu had committed insider trading when they sold Cheetah Mobile ADS ahead of the May Announcement.<sup>14</sup> While aware of the negative revenue trends, Fu and Xu jointly created a 10b5-1 trading plan in March 2016. By selling 96,000 Cheetah Mobile ADS through the plan before the May Announcement, the two avoided losses of \$303,417, collectively.<sup>15</sup> The Order also found that Fu had misled analysts and investors, as well as failed to fully disclose the declining revenue trend in Cheetah Mobile's Form 20-F filing.<sup>16</sup>

Notably, the SEC's Order requires that for five years, Fu's 10b5-1 plans cannot make any securities transaction for a cooling-off period of 120 days after his plans have been adopted or modified.<sup>17</sup> In addition, for five years, Fu cannot maintain more than one 10b5-1 plan at once with respect to Cheetah Mobile securities. Fu and Xu also agreed to pay civil penalties of \$556,580 and \$200,254, respectively.<sup>18</sup>

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### IMPLICATIONS

This SEC enforcement action provides several informative insights into its reshaping of Rule 10b5-1.

*First*, the Order could indicate that a formal rule adopting the proposed Rule 10b5-1 amendments is forthcoming. The SEC's June 2022 Regulatory Agenda indicated that the final action on the proposed Rule 10b5-1 amendments is expected in April 2023.<sup>19</sup> The undertakings in the Order primarily touch upon just two aspects of the proposed amendments, but the Order could signify that the SEC's other proposals

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will be adopted as well, such as requiring new company disclosures regarding 10b5-1 practices and policies.<sup>20</sup>

*Second*, even without a formal amendment, the Order could set the baseline for how companies and employees structure 10b5-1 plans, creating a new industry standard of compliance.

*Third*, the Order underscores the SEC's continued focus on individual penalties and deterrence. As explained by Director of Enforcement Gurbir Grewal (discussed [here](#)), the SEC has been looking to "design penalties that actually deter and reduce violations," especially where previously imposed penalties have not achieved their "intended deterrent effect."<sup>21</sup> The monetary penalties in the Order could thus catalyze conformity by members of the industry to the newly proposed Rule 10b5-1 standards.

While it remains to be seen if the SEC will adopt its Rule 10b5-1 amendments as proposed, this enforcement action might signal what to expect from the SEC and how the industry should adjust in preparation.

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ENDNOTES

- 1 17 C.F.R. § 240.10b5-1 (2022).
- 2 See Sec. & Exch. Comm'n Rel. Notice, Rel. No. 33-7881, *Selective Disclosure and Insider Trading* (Aug. 15, 2000), available at <https://www.sec.gov/rules/final/33-7881.htm>.
- 3 17 C.F.R. § 240.10b5-1(c).
- 4 *Id.* § 240.10b5-1(c)(1).
- 5 See Sec. & Exch. Comm'n Rel. Notice, Rel. No. 33-11013, *Rule 10b5-1 and Insider Trading* (Dec. 15, 2021), available at <https://www.sec.gov/rules/proposed/2021/33-11013.pdf>.
- 6 See Letter from Jay Clayton, former Chair of the SEC, to Representative Brad Sherman, former Chairman of the House Financial Services Committee (Sept. 14, 2020), available at <https://www.sec.gov/files/clayton-letter-to-chairman-sherman-20200914.pdf>.
- 7 See Gary Gensler, "Prepared Remarks for CFO Network Summit" (June 7, 2021), available at <https://www.sec.gov/news/speech/gensler-cfo-network-2021-06-07>.
- 8 See Recommendation of the Investor Advisory Committee Regarding Rule 10b5-1 Plans (Sept. 9, 2021), available at <https://www.sec.gov/spotlight/investor-advisory-committee-2012/20210916-10b5-1-recommendation.pdf>.
- 9 See *Rule 10b5-1 and Insider Trading*, Rel. No. 33-11013 (Dec. 15, 2021).
- 10 See *In the Matter of Sheng Fu and Ming Xu*, Exchange Act Rel. No. 95847 (Sept. 21, 2022), at 2, 4, available at <https://www.sec.gov/litigation/admin/2022/33-11104.pdf>.
- 11 *Id.* at 4–5.
- 12 *Id.* at 5.
- 13 *Id.* at 7.
- 14 *Id.* at 7–8.
- 15 *Id.* at 7.
- 16 *Id.* at 6.
- 17 *Id.* at 9.
- 18 *Id.*
- 19 See Press Release, *SEC Announces Spring 2022 Regulatory Agenda* (June 22, 2022), available at <https://www.sec.gov/news/press-release/2022-112>.
- 20 See *Rule 10b5-1 and Insider Trading*, Rel. No. 33-11013 (Dec. 15, 2021).
- 21 Gurbir S. Grewal, "PLI Broker/Dealer Regulation and Enforcement 2021" (Oct. 6, 2021), available at <https://www.sec.gov/news/speech/grewal-pli-broker-dealer-regulation-and-enforcement-100621>.

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