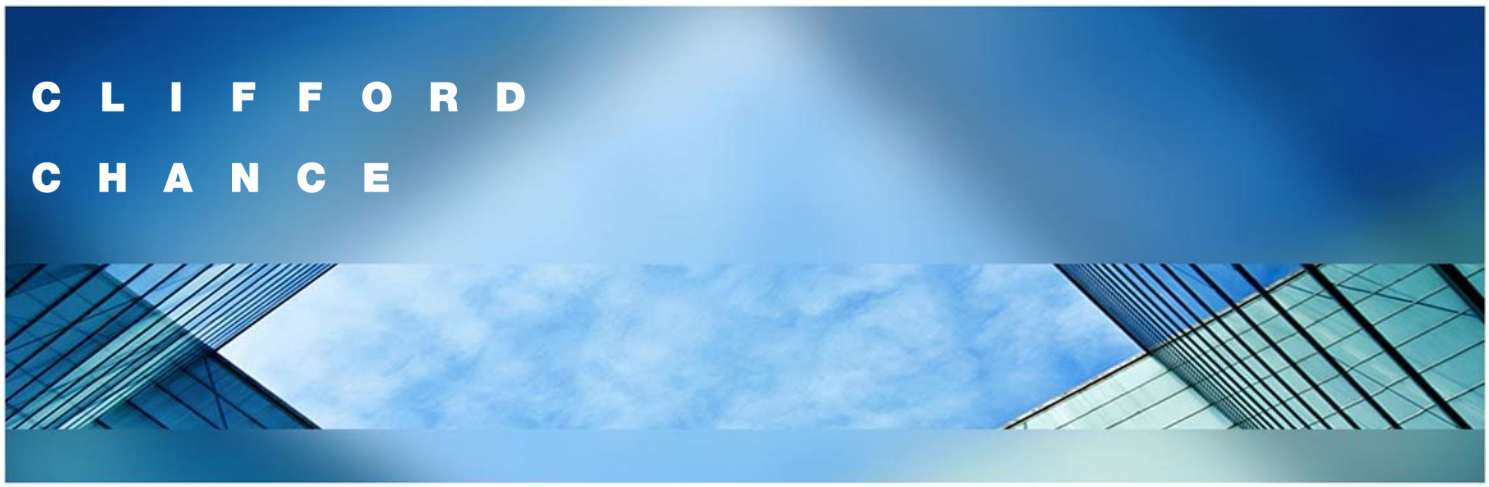

THE "WHOA" FACTOR: THE SEC APPLIES A NOVEL THEORY TO 10B5-1 PLANS AND SENDS A MESSAGE

In October 2020, the Securities and Exchange Commission announced a cease and desist order against Andeavor LLC[1], a publicly-traded energy company, relating to a 10b5-1 plan adopted by Andeavor. The SEC concluded that Andeavor possessed material non-public information ("MNPI") at the time it entered into the 10b5-1 plan. What makes this order unique is that the SEC did not charge the company with a violation of Rule 10b5-1. Rather, the SEC found that the company's internal accounting controls were insufficient to ensure that the buyback program was conducted in accordance with the corporate authorization for the program, which required that the buyback be conducted in accordance with the company's insider trading policies. This appears to be a first of its kind order in the insider trading area, and in house legal teams in particular should pay attention to the SEC's focus on internal processes and consider making adjustments to their own processes.

The Facts

In March 2017 the CEO of Andeavor and the CEO of Marathon Petroleum Corporation first discussed a potential business combination. In August 2017, the companies signed a confidentiality agreement and began sharing information. Bankers and counsel for both parties were involved. At the end of October 2017, the Marathon CEO suspended discussions over valuation issues and potential dilution. At the request of Marathon's CEO, the parties resumed discussions about a potential transaction on January 30, 2018 and scheduled an in-person meeting for February 23. Marathon's share price had increased since the parties had suspended discussions the previous October, ameliorating Marathon's diligence concerns.

[1] In the Matter of Andeavor LLC, Securities Exchange Act of 1934 Release No. 90208, October 15, 2020.

The Andeavor CEO informed the Andeavor board about the resumption of discussions on February 11, 2018, and the board expressed its support for resuming discussions on February 14.

On February 21, 2018, the Andeavor CEO directed the Andeavor CFO to initiate a $250 million share buyback. The buyback was conducted pursuant to a $2 billion program authorized by the company's board of directors in 2015 and 2016. According to the SEC, the authorization mandated that any repurchase was required to comply with the company's trading policy which, among other things, prohibited the company from entering into a 10b5-1 plan while it was in possession of MNPI.

Andeavor's legal department approved a new 10b5-1 plan to repurchase up to $250 million of shares on February 22, 2018. Negotiations between Andeavor and Marathon resumed on February 23, 2018 and the companies publicly announced a transaction on April 30, 2018. Andeavor purchased shares in the open market between February 23 and March 28, 2018.

The SEC order states that the legal department's decision to approve the 10b5-1 plan on February 22, 2018 was "based on a deficient understanding of all relevant facts and circumstances regarding the two companies discussions" that the discussions did not constitute MNPI.

Insufficient Internal Accounting Controls

The SEC blamed Andeavor's "informal internal processes" for the legal department's faulty conclusion. The main flaw cited by the SEC was that no one from the legal department who was involved in approving the 10b5-1 plan discussed with the CEO the prospects of a transaction coming to fruition. As a result, the legal department did not fully appreciate the probability of the transaction. Thus, the SEC concluded, Andeavor violated §13(b)(2)(B) of the Securities and Exchange Act of 1934, as amended, because it did not have internal accounting controls that provide reasonable assurance that the buyback would be executed in accordance with the board's authorization. Andeavor agreed to pay the SEC a civil fine of $20.0 million and to cease from violating §13(b)(2)(B) in the future. Note that the SEC reached its conclusion that there was an internal control failure even though the Andeavor CEO approved the buyback.

Why is this Case interesting?

We think this case is interesting for two reasons:

1. A Rare Case and a Novel Theory – The SEC has not brought many enforcement cases involving stock buybacks, and the SEC did not charge Andeavor or any of its executives with fraud or insider trading. It charged the company with a failure to maintain adequate accounting controls. One may not readily consider the decision to enter into a trading plan to be the subject of accounting controls.
2. Everyday Decisions – Giving advice on whether a company possesses MNPI is something that internal lawyers and outside counsel do regularly. The issue comes up in the context of entering into 10b5-1 plans or one-off trades, and conducting offerings. Advisors should carefully review their

internal processes and consider whether they would hold up to scrutiny in hindsight.

This enforcement action appears intended more as a lesson to company management and legal counsel than a revelation of bad behavior. The facts set forth in the order are not the types of obvious examples of recklessness or bad intent that we often see in enforcement cases.

Lessons that we think should be taken from the Andeavor order are:

1. *Trading triggers heightened scrutiny*. When assessing the magnitude and probability of information, one must consider the influence of 20/20 hindsight on probability. Andeavor entered into the 10b5-1 plan one day before a planned meeting of the companies' CEOs. While we cannot know whether Andeavor management considered the transaction to be probable at that time, and it took another two months for the parties to reach a binding agreement, it would be unrealistic to think that the 20/20 hindsight view of a meeting that culminated in a binding agreement within two months had no influence on the SEC's view of the company's actions.

   This case reminds practitioners that there is a continuum of scrutiny in making materiality calls from the pure disclosure regime to the trading regime. There is no line item requirement in Form 8-K to report preliminary merger discussions, and it is understood that preliminary discussions need not be disclosed in the MD&A section of a 10-Q or 10-K. When a company wants to trade in its securities or offer securities; however, the materiality call on the same information requires practitioners to use a different lens, and to account for 20/20 hindsight when doing so.

2. *Process, process, process*. As we have noted, the SEC's order is based on an internal control violation. The SEC connected the mandate of the corporate authorization that the 10b5-1 plan be conducted in accordance with the company's insider trading policy with the lack of a discussion between the legal department and the CEO, and concluded that Andeavor did not have sufficient controls in place to ensure compliance with the mandate in the corporate authorization, even though the CEO separately approved the buyback.

   As with many other aspects of public company life, process matters. Internal and external counsel should ensure that there are controls around buyback decisions and other situations where a materiality judgment must be made before a company buys or sells its securities. In particular, legal advisors should ensure that a discussion takes place between the legal department and the senior most decision makers if the company is considering material transactions.

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