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FLAWED 10B5-1 PLAN LEADS TO INSIDER TRADING FINDING AGAINST EXECUTIVES

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A recent SEC order found that two executives of Cheetah Mobile Inc. engaged in illegal insider trading when selling shares under a purported 10b5-1 trading plan. The SEC found that they established the plan after learning of a significant drop-off trend in advertising revenues from the company's largest advertising partner (the AdPartner) that the company had not yet disclosed. They then sold 96,000 American Depository Shares under the plan and avoided losses of approximately $203,290 and $100,127, respectively, by making those sales prior to disclosure of the trend and its effect.

Rule 10b5-1 can provide an affirmative defense to insider trading charges, but only if the plan is established in good faith at a time when the person is unaware of material nonpublic information. Here, the SEC found that the plan did not comport with the requirements of Rule 10b5-1 because, when creating the plan, the executives were aware of material nonpublic information. This case underscores the importance of confirming the availability of all of the elements of the defense – a task that will become harder if proposed rule changes are approved.

Background

In 2015 and 2016, the company was focused on developing mobile and computer applications, mobile games and other internet-related products, earning up to one-third of its revenues by placing within its applications third-party advertisements provided by the AdPartner. In mid-2015, the AdPartner informed the company that it was going to change its algorithm that determined fees for ad placements and that, unless the company improved the quality of ad placements, the new algorithm could halve revenues from the AdPartner.

The company earned $52.1 million in revenues from the AdPartner in the third quarter of 2015 but only $46.4 million in the fourth quarter– an 11% decline representing 3% of total fourth-quarter revenue, which the SEC deemed “significant.” Revenue from the AdPartner declined even further in the first quarter of 2016 to $32.7 million – a 30% decline, representing 8% of total first quarter revenue.

In a face-to-face meeting with the AdPartner, the CEO expressed concern that the algorithm change would result in revenue decline and cause the company to fail to meet its own revenue targets and Wall Street expectations. In emails sent to the AdPartner in late 2015, the then President and Chief Technology Officer (CTO) similarly expressed concerns about the revenues and potential Wall Street reaction in the event of a significant revenue decline.

Despite this known negative trend, during a quarterly conference call with analysts and investors in March 2016, the CEO ascribed the "softness" in first-quarter 2016 revenue guidance primarily to greater-than-expected "seasonality." The SEC concluded this explanation was materially misleading because the CEO failed to disclose the algorithm change and the negative impact on revenue, and failed to disclose that the negative trend was persistent and not seasonal in nature. The company also failed to disclose the trend in its annual report on Form 20-F filed in April 2016.

In late March 2016, while aware of the trend, which at such time was material non-public information, the two executives established a trading plan for selling some of their shares through a jointly-held entity. The company's policy prohibited employees from trading in its securities and from establishing 10b5-1 trading plans while in possession of material nonpublic information. The SEC order also stated that, as officers, the executives owed a duty to refrain from using its confidential information for their own personal gain. In May 2016, the company announced its lower-than-expected second-quarter 2016 revenue guidance and that it did not expect to meet its full year revenue and earnings guidance. Afterwards, its stock price declined by 18%. The executives avoided losses in the aggregate amount of $303,417 by selling securities under the plan prior to the May announcement.

Violations, undertakings and order

The SEC found that both executives violated Section 10(b) and Rule 10b-5 which prohibit fraudulent conduct in connection with the purchase or sale of securities. In addition, the CEO was found to have violated Sections 17(a)(2) and (3), the antifraud provisions of the Securities Act which do not require scienter and may rest on a finding of negligence. He was also found to have caused the company's violations of Section 13(a) and Rules 12b-20 and 13a-1 of the Exchange Act relating to the filing of inaccurate reports.

For five years:

- Both executives are required, among other things, to notify the SEC of any US securities account they maintain. They are also required to notify the SEC within 48 hours if they engage in any transaction in company securities, including derivatives, or open any US securities account. They are prohibited from trading company securities in any accounts other than those disclosed to the SEC.
- The CEO is required to notify the SEC within 48 hours if he enters into or modifies or cancels any 10b5-1 plan with respect to company securities. He is also prohibited from maintaining

more than one 10b5-1 plan at any time with respect to company securities and is required to include a cooling-off period of at least 120 days between the date of adoption or modification of the plan and the execution of trades.

- Both executives are required to certify annually as to their compliance with their respective undertakings as set forth in the order and to provide written evidence of compliance, supported by exhibits.

The CEO and the executives agreed to cease and desist orders relating to specified securities laws and to pay civil money penalties in the amounts of $556,580 and $200,254, respectively.

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- Securities & Corporate Governance

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