

# Insufficient Internal Controls Result in SEC Enforcement in Connection with Rule 10b5-1 Plan

October 23, 2020

On October 15, 2020, the Securities and Exchange Commission (“SEC”) announced a \$20 million settlement resulting from a finding of insufficient internal controls at Andeavor LLC (“Andeavor”). The SEC found that Andeavor violated an Exchange Act provision requiring the implementation and maintenance of effective internal controls through its improper initiation of, and repurchase of shares pursuant to, a Rule 10b5-1 plan while in possession of material non-public information (“MNPI”) and in violation of Andeavor’s internal policies. The SEC’s focus on appropriate internal controls highlights the importance of maintaining proper procedures and communications within a public company.

## BACKGROUND

In 2017, Andeavor, a Texas-based energy company, engaged in significant discussions with Marathon Petroleum Corporation (“Marathon”) about, and began working toward, a potential business combination. Discussions were halted in the fourth quarter of 2017, but in January 2018, Marathon’s chief executive officer indicated to Andeavor’s chief executive officer that the company was prepared to move forward with merger discussions. In the days prior to the resumption of negotiations, Andeavor’s chief executive officer directed the company to repurchase \$250 million of shares under a share repurchase program that had been previously adopted by Andeavor’s Board of Directors. As a result, Andeavor purchased its stock on the open market between late February and late March 2018, as negotiations were ongoing with Marathon, at a price of no more than \$103 per share. On April 30, 2018, Andeavor publicly announced the merger at a price of over \$150 per share.

Andeavor’s Board of Directors’ authorization for the share repurchase program specifically required that any purchases comply with Andeavor’s securities trading policy, which prohibited purchases of shares by the company while the company was in possession of MNPI. Before the Rule 10b5-1 plan was initiated, Andeavor’s legal department reviewed and approved of the plan; a review which the SEC order described as “abbreviated and informal.”

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## ENFORCEMENT ACTION AND SETTLEMENT

The SEC concluded that Andeavor's internal controls were deficient as they failed not only to ensure that the Rule 10b5-1 plan would be approved and executed in accordance with Andeavor's internal policies, but also failed to ensure that those involved in the approval process were aware of material company information so as to allow for a proper analysis of the probability of an acquisition transaction with Marathon. In particular, the SEC noted that Andeavor's chief executive officer, a key participant in the Marathon negotiations, was not directly consulted, and was not required to be consulted by Andeavor's policies, prior to approval of the Rule 10b5-1 plan by the legal department. By failing to consult with the chief executive officer, the SEC asserted that "the company failed to appreciate that the probability of Andeavor's acquisition by Marathon was sufficiently high at that time as to be material to investors."

Andeavor's conduct resulted in a violation of Section 13(b)(2)(B) of the Securities Exchange Act of 1934 which require a public company to devise and maintain effective internal accounting controls. Andeavor settled without admitting or denying the SEC's findings and agreed to pay a civil money penalty of \$20 million.

## ANALYSIS

Review of the SEC order begs the question of why the SEC did not pursue an insider trading action. Although we can only speculate, it would appear that the SEC could not adequately support a finding that the actions of the legal department in approving the Rule 10b5-1 plan, based on the facts available to them, implicated a 10b-5 violation. Indeed, it was the chief executive officer who directed the repurchase and was cognizant of the state of play regarding the discussions with Marathon. While potentially critical to its analysis that the legal department was not aware of the information in the possession of the chief executive officer as to the probability of the company being acquired, the SEC might also have faced a difficult burden in proving the materiality of those ongoing merger negotiations at the time of the trading, given that they took place one-two months prior to the announcement of the transaction. The case raises a number of other questions, including whether it is appropriate to read the internal controls provisions so broadly as to cover policies related to trading; whether the case also implicates disclosure controls and procedures considerations; and whether it could heighten the risk that, with similar facts in the future, the SEC would choose to pursue an enforcement action for a 10b-5 violation.

The case highlights the need for public companies to evaluate their internal corporate governance policies and procedures, communications practices and documentation

procedures. In particular, to ensure that a company is not in possession of MNPI when it decides to trade, prior to trading or adopting a Rule 10b5-1 plan, the company should ensure that the proper executives are consulted regarding any material company information or decisions, including any pending consequential transactions. The SEC order does not specifically mention any consultation between Andeavor and its outside counsel, but it would be prudent to consult outside counsel if any questions on corporate governance or insider trading concerns arise. Consideration of possession of potential MNPI should be given more than a cursory review by a company, including its legal department and senior management team.

The SEC order can be found at this [link](#).

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