COVID-19 and U.S. Insider Trading Concerns: The Division of Enforcement Speaks Out

March 27, 2020

On Monday, March 23, 2020, the Co-Directors of the SEC's Division of Enforcement issued a rare Public Statement warning public companies and their directors, officers and other "insiders" to be especially mindful of their obligations under the U.S. securities laws during the COVID-19 pandemic. The Public Statement may be accessed here**.**

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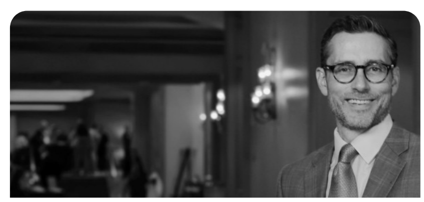

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Dissemination and Use of Material Nonpublic Information

Acknowledging the "unprecedented ways" in which the pandemic has already affected the markets, the Co-Directors cautioned public companies to be "mindful" of their established insider trading policies, codes of ethics, and communication policies to "ensure to the greatest extent possible that they protect against the improper dissemination and use of material nonpublic information."

The Co-Directors noted that as a result of the unique circumstances surrounding the COVID-19 pandemic "corporate insiders are regularly learning new material nonpublic information that may hold an even greater value than under normal circumstances" and more people may have access to more material nonpublic information "than in less challenging times." In the Statement, the Co-Directors urged that persons with such access, including officers, directors and other insiders, must be vigilant about keeping the information confidential and comply with prohibitions on illegal insider trading.

As companies near the end of their fiscal quarter, many officers and directors are subject to insider trading policy blackout restrictions because of the likelihood that they are aware of material non-public information about quarterly results. At the moment, as noted by the Co-Directors, these insiders are also likely to be aware of the pandemic's impact on their businesses. The Public Statement underscores that when the COVID-19 crisis subsides, the SEC's Enforcement Division will look hard at trading activity by insiders during this time. Obviously, any trading that occurs shortly before the end of the quarter and before the public announcement of results will be particularly suspect, as insiders potentially have an early, material and nonpublic view of the impact of COVID-19 on their business. It seems logical that some businesses (including airlines, hotels, cruise lines and restaurants) will be the subject of greater scrutiny than others, but because the impact of COVID-19 is being felt across all industries, no businesses are immune.

During the aftermath of the 2008 financial crisis, the SEC brought several cases alleging that insiders traded based on material non-public information. Some of these cases alleged that traders were tipped about imminent losses in companies or funds.[1] One action against former Galleon Group CEO Raj Rajatnam resulted in a record-setting 2011 judgment imposing a financial penalty of $92.8 million for engaging in insider trading to reap illegal profits and avoid losses.[2]

Margin Calls: Insider Trading and Related Concerns

Since late February, the coronavirus has been blamed for huge drops in global equity prices, which have suffered aggregate decreases estimated at about 30% of their prior market value as of March 21. These are triggering margin calls across the brokerage industry. Many public companies implemented "no pledge" provisions regarding company stock in their insider trading policies after the 2008 financial crisis. For those that did not, officers or directors may have pledged company stock in margin accounts, and even for companies with such policies, some insiders may not have understood the prohibition and pledged company securities. These insiders now may be facing margin calls due to a drop in share value.

The 2008 financial crisis triggered margin calls involving several high profile insiders. In 2012, the founder of Green Mountain Coffee lost his job as CEO as a result of the forced sale of shares to cover a margin call after the company announced disastrous results, but while still in a blackout period. Such sales could violate the antifraud provisions of the securities laws if the insider possesses material non-public information. For example, where an insider possessing such material information experiences a margin call on company securities has the option to cover that call with other securities, but chooses not to do so, any resulting sale of company securities could be attributed to her. In that case, the insider is likely violating the company's insider trading policy by trading during a blackout period and may be violating federal law by allowing trading in her account while in possession of material nonpublic information.

The prospect of margin calls and forced sales of company stock implicate additional legal concerns beyond insider trading. There is no exception from Section 16(b) for forced sales as a result of margin calls. These are non-exempt sales requiring reporting on Form 4 within two business days, and are matchable with any opposite-way transactions within six months. Form 4 filings near the end of the quarter or before announcement of results are likely to draw the attention of both the SEC Enforcement Division as well as shareholder plaintiffs' counsel.

Issuers themselves may have insider trading and/or 10b-5 liability in connection with forced sales. Section 20(a) of the Exchange Act creates control person liability for any entity that has control of another person engaged in insider trading, unless the controlling person acted in good faith and did not directly or indirectly induce the acts constituting the violation. As for 10b-5 liability, if the insider's pledge of company shares was not properly disclosed (for example, in the management beneficial ownership table in the proxy statement), a significant stock drop resulting from forced margin account sales could precipitate shareholder derivative suits against the company. What the company does in response to learning of the forced sales is very important and will likely be scrutinized by many in a later action against the company for securities laws violations, breach of fiduciary duty, and disclosure violations. The company should also consider the market's reaction, or potential reaction, to forced sales and determine whether the fact of the margin call and forced sales are themselves material nonpublic information.

What Companies Can Do

As noted above, the Co-Directors of the SEC Division of Enforcement want companies to be mindful of protecting against the improper dissemination and use of material non-public information. With so many people working remotely and companies implementing alternative reporting procedures, companies should take steps to remind employees of the confidential nature of the company's information, the terms of the company's disclosure and insider trading policies, and reiterate (and possibly expand) blackout periods and preclearance of trades.

Companies should also review their insider trading policies to ensure that the blackout and any preclearance processes appropriately extend to persons receiving material nonpublic information during the COVID-19 pandemic. Those policies may require amendment if they do not provide for temporary expansions of those groups. Companies also may want to review the treatment of pledged securities under their current policy and ensure that such treatment remains appropriate for the company. The policy should then be disseminated to all directors and affected employees with a reminder of the policy's terms, and a request that they acknowledge having reviewed them. If a company finds that its insiders face forced sales of margined company stock, it must evaluate the facts and circumstances of the matter. The company should then take appropriate action, taking into account, among other considerations, shareholder and market optics on one end of the spectrum, and liability for insider trading, disclosure violations and 10b-5 claims on the other. Current disclosure to the market may be necessary.

For further information on this topic, please contact Therese Pritchard, Ashley Ebersole, LaDawn Naegle or any other BCLP Regulation, Compliance & Advisory or Securities and Corporate Governance or lawyer. Our firm has established a COVID-19 Securities and Corporate Governance sub-group to assist clients with advice on these issues, and who can be contacted at: COVID-19SecuritiesCorporateGovernance@bclplaw.com.   Additional resources are available on our Website pages for theRegulation, Compliance & Advisory Practice, BCLP Securities and Corporate Governance Practice, or our COVID-19 Resource Center. Bryan Cave Leighton Paisner LLP makes available the information and materials in its Website for informational purposes only. The information is general in nature and does not constitute legal advice. Further, the use of this site, and the sending or receipt of any information, does not create any attorney-client relationship between us. Therefore, your communication with us through this Website will not be considered as privileged or confidential.

1. SEC v. Gupta & Rajaratnam, 102 S.E.C. Docket 1179 (Oct. 26, 2011); David W. Baldt, 98 S.E.C. Docket 1544 (May 11, 2010).

2. SEC v. Rajaratnam, 822 F. Supp. 2d 432 (S.D.N.Y. Nov. 8, 2011).

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