AUTHORITIES ARE ON ALERT FOR INSIDER TRADING – IS YOUR BUSINESS AT RISK?

Hodgson Russ Business Litigation and Securities Regulation & Corporate Compliance Alert
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The Coronavirus pandemic is disrupting every aspect of the American economy and inflicting deep financial pain on millions of households. The uncertainty this disaster has engendered, and the frequency with which significant events are occurring, has the financial markets jumping and sinking more violently than usual. Officers, directors, and employees have more access to valuable inside information than in ordinary times. And, due to a recent legal development, federal prosecutors can more easily charge and prosecute insider trading than before.

Publicly traded companies, along with entities privy to their material, nonpublic information (MNPI), should carefully address this confluence of circumstances. Even when the company and its executives are not sued or charged, government investigations into wayward employees are inevitably distracting, unflattering, and expensive, and they may spawn private-party litigation. While management and in-house counsel are already dealing with dozens of novel problems spawned by the pandemic, by simply deploying a few modest countermeasures, they can help ensure that an insider-trading episode does not siphon away time, money, and focus that is better spent on other priorities.

1. **A Flood of Market-Moving Information in a Market Primed to Move.**

In a crisis, especially a novel one, uncertainty is high and events unfold with unusual velocity. As the Securities and Exchange Commission explained in a recent statement, "in these dynamic circumstances, corporate insiders are regularly learning new material nonpublic information that may hold an even greater value than under normal circumstances," especially "if earnings reports or required SEC disclosure filings are delayed due to COVID-19." In addition, "a greater number of people may have access to material nonpublic information than in less challenging times."[1]

The healthcare sector is one obvious example. Senator Richard Burr's advance knowledge of the impending public-health crisis has raised questions about his contemporaneous sell-off and reportedly prompted a Justice Department investigation. Likewise, over the coming months, breakthroughs in Coronavirus testing, treatment, and vaccination will present trading opportunities for those with advance knowledge.

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Identical opportunities arise in fields well beyond healthcare. Even unsophisticated investors may be able to readily capitalize on non-public news of a major supply-chain disruption, or an outbreak at a large factory, or a regulatory decision allowing a company to operate throughout the emergency.

The SEC has stated that it will devote substantial resources to enforcement during this crisis. As always, its efforts will be augmented by federal prosecutors. And, while criminal prosecution is ordinarily reserved for the most serious cases, due to a recent legal development, ***conduct that is insulated from civil enforcement may now be vulnerable to criminal prosecution***.

2. A Very Brief Summary of Insider-Trading Prohibitions.

Historically, the SEC and federal prosecutors have brought insider-trading cases under 15 U.S.C. § 78j(b) and 17 C.F.R. § 240.10b-5, which prohibit fraud in connection with the purchase or sale of a security. Title 15 enforcement has proceeded primarily under two theories.

The classical theory. The classical theory of insider trading springs from the duty that a corporate insider owes to her corporation and, indirectly, to the corporation's shareholders. Suppose that the vice president of Pharma Co. buys heaps of company stock after learning that its top product, BestPill, may have utility as a treatment for Coronavirus. Unless she disclosed this information first, the vice president's purchases breached her duty to the selling shareholders and violated Title 15.

The misappropriation theory. What if the lawyer Pharma Co. hired to pursue regulatory approval for BestPill used his knowledge to buy stock in Pharma Co.'s *suppliers*? The classical theory would not capture this situation because the lawyer owed no duty to the shareholders of other companies. Enter the misappropriation theory, which springs from the duty a possessor of MNPI owes to the information's source. Pharma Co. gave outside counsel confidential information about BestPill's prospects so he could advance Pharma Co.'s interests before the FDA. By misusing that information to enrich himself, the lawyer likely defrauded Pharma Co. and violated Title 15.

Tipping liability. In many cases, the person holding MNPI does not trade for her own account, but instead passes the MNPI to someone else on the understanding that this person, the tippee, will trade. Under Title 15, a tipper is liable only if she provides MNPI in exchange for a personal benefit. Likewise, a tippee is liable only if she knows or has reason to know that the tipper received a personal benefit. The personal-benefit requirement is most apt to impede enforcement actions against

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remote tippees—that is, tippees who are several steps removed from the original disclosure. The personal-benefit requirement also has been much debated in the courts, and to this day the concept is muddy at the margins.

Prosecutors turn to Title 18. To sidestep the personal-benefit problem, federal prosecutors began charging insider trading under 18 U.S.C. § 1343 (wire fraud) and 18 U.S.C. § 1348 (securities and commodities fraud). The government argued that these statutes do not require a showing of personal benefit.

A few months ago, the Second Circuit Court of Appeals endorsed the government's position. In *United States v. Blaszczak*, 947 F.3d 19 (2d Cir. 2019), a federal employee gave advance notice of impending regulatory action to a political-intelligence consultant, who passed the information to a hedge fund. The defendants were charged with fraud under both Title 15 and Title 18. At trial, the district court instructed the jury that only the Title 15 charges required the government to prove a personal benefit to the tipper that was known to the tippees. The jury acquitted on the Title 15 charges and convicted on most of the Title 18 charges. On appeal, the Second Circuit held that the jury was properly instructed. The schemes to defraud proscribed by Title 18 include embezzlement, defined as the fraudulent appropriation of money or goods entrusted to one's care by another. The defendants in *Blaszczak*, the court held, had embezzled the agency's property when they fraudulently appropriated to their own use information entrusted to the agency employee.

Blaszczak offers an easier path to insider-trading convictions, and it may encourage prosecutors to cast a wider net when charging these cases. *Blaszczak* does not affect civil actions brought by the SEC, however, as the SEC does not enforce Title 18. As a result, certain types of conduct may be more susceptible to criminal prosecution than to civil enforcement. This paradox could prompt Congress to overrule *Blaszczak*, or do away with the personal-benefit requirement altogether. *Blaszczak* also may not survive a petition for Supreme Court review.[2] For now, though, prosecutors in the Second Circuit, home to most insider-trading cases, have judicial approval for a powerful new tool.

3. **A Few Modest Countermeasures.**

Most public companies employ a package of policies and procedures to guard against insider trading. First, they reduce opportunities for insider trading by limiting employee access to MNPI and making robust, timely disclosures to the marketplace. Second, they implement various trading protocols. To manage insiders' trading in company stock, they institute blackout periods and encourage insiders to use Rule 10b5-1 trading plans. Preclearance policies aim to prevent trading on other companies' MNPI.[3] Third, public companies train employees about the obligation to refrain from trading on or tipping MNPI.

Any public company that has not instituted some version of these countermeasures should do so promptly. And the businesses that serve them—law firms, consultants, analysts, and so on—should consider doing the same.

Companies that have already enacted these basic preventative measures should ask themselves three questions:

1. Are the right people subject to blackout periods and preclearance requirements? The typical blackout or preclearance protocol applies only to those individuals most likely to have access to MNPI. But the way information moves through a company changes over time. When companies fail to adjust their protocols accordingly, these devices lose some of their efficacy.

2. Does management have enough information to make disclosure and blackout decisions? Blackout protocols usually allow management to impose ad hoc blackout periods (or disclose to the marketplace, when appropriate) for one-off material events. But this flexibility does little good unless the right people have the information they need to make an informed judgment. Be sure they do.
3. Are you periodically reminding employees about their obligations? Consistent reminders will keep insider-trading prohibitions top of mind during this period of heightened risk. Reminders are especially important to prevent tipping, which is not fully addressed by trading plans or blackout periods and may be more likely in circumstances where home time and work time are increasingly blended.

If you have questions about insider-trading policies and procedures, contact Craig Fischer (716.848.1266). If you have questions about enforcement actions, contact Spencer Durland (716.848.1377) or Tim Hoover (716.848.1271).

Please check our Coronavirus Resource Center and our CARES Act page to access additional information related to both of these rapidly evolving topics.

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[1] *See* Securities & Exchange Comm'n, *Statement from Stephanie Avakian and Steven Peikin, Co-Directors of the SEC's Division of Enforcement, Regarding Market Integrity*, https://www.sec.gov/news/public-statement/statement-enforcement-co-directors-market-integrity (Mar. 23, 2020).

[2] On April 10, 2020, the Second Circuit denied the defendants' motions to rehear the case.

[3] A Rule 10b5-1 trading plan allows company insiders to sell or purchase a predetermined number of shares through a broker at a time in the future subject to certain pre-established criteria, provided that the insider does not hold MNPI when she establishes the plan and does not influence how and when the broker buys or sells company stock. A blackout period is a period during which certain individuals cannot trade company stock. Blackout protocols typically include both a quarterly restriction associated with the company's regular earnings releases, and an ad hoc restriction for use in connection with one-off events like significant mergers and joint ventures. A preclearance policy bars employees from trading in the stock of listed companies absent approval from the firm's legal or compliance department. Companies appear on the preclearance list when the firm obtains their MNPI, and are removed when the information becomes public.