

## ■ SECURITIES ENFORCEMENT

# Insider Trading in the Time of COVID-19: Risks and Best Practices

*The opportunity to engage in COVID-19 insider trading has increased significantly. The SEC has indicated it is closely scrutinizing securities trading of market insiders and insider trading allegations can form a basis for private securities class actions and derivative litigation.*

By Ghillaine A. Reid, Jay A. Dubow,  
and Kaitlin L. O'Donnell

The corporate world is facing financial upheaval and an unprecedented earnings season, with the novel coronavirus and COVID-19 disrupting the securities markets in unique and wide-ranging ways. In this time of economic uncertainty, opportunity and motive to engage in COVID-19-related insider trading has increased significantly. The Enforcement Division of the Securities and Exchange Commission (SEC) already has advised that, in its effort to maintain market integrity during the COVID-19 pandemic, it will scrutinize more closely the securities trading of corporate insiders. Further, insider trading allegations often form a basis for private securities class actions and derivative litigation, filings of which also are likely to rise in the coming weeks and months.

Consequently, it is vital that public companies reflect on the ways in which the current pandemic has expanded opportunities for corporate executives, and others, to trade on material, nonpublic information. This article addresses the ways in which the current pandemic has heightened opportunities and motives to engage in insider trading, the potential adverse effects of such transactions, and best practices

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**Ghillaine A. Reid** is an attorney at Troutman Sanders LLP. **Jay A. Dubow** and **Kaitlin L. O'Donnell** are attorneys at Pepper Hamilton LLP.

for preventing trading on material nonpublic corporate information during these challenging times.

## Increased Opportunity and Motive for Insider Trading

In an effort to both stem the tide of the pandemic and soften its impact, several federal and local governmental bodies have issued orders placing restrictions on and providing relief for businesses and individuals. Together, these restrictions and relief actions have increased significantly both the opportunity and motive for individuals to trade on material nonpublic corporate information, thereby heightening the risk that companies will face government investigations or SEC enforcement actions related to COVID-19 insider trading.

Businesses around the globe are struggling with the economic effects of COVID-19, as companies have been forced to shut down for significant periods or drastically alter their business models in response to government regulations aimed at decreasing the virus's spread. To provide relief for companies as they attempt to determine what material impact COVID-19 may have on their financial statements and public disclosures, the SEC has issued an exemptive order which provides public companies with a 45-day extension to file periodic disclosure reports, such as Forms 10-K and 10-Q, which customarily would be filed between March 1 and July 1 of this year.<sup>1</sup>

Though undoubtedly helpful for many companies, the SEC's 45-day filing extension, combined with the significant impact COVID-19 has had on most businesses, creates an environment ripe for insider trading and other anti-fraud violations. Insider trading occurs when individuals rely on material nonpublic corporate information to buy or sell stock. For public

companies that take advantage of the SEC's filing extension, their corporate insiders likely will have access to—and the ability to trade on—material corporate information for an extended time before that information is made available to investors. Further, company insiders are likely to have nonpublic information not only regarding how COVID-19 might impact their own companies' financials, but also regarding how the pandemic might impact other entities, including customers, vendors, and other third parties with which their companies interact. Given the severe impact that COVID-19 has had on virtually all industries, much of the nonpublic information regarding its impact is likely to be material. Together, these factors create unique and unprecedented opportunities for insider trading.

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Pandemic restrictions have resulted in additional opportunities for insider trading, beyond those created by the SEC's recent filing extension. Remote working also presents unique opportunities for disseminating—advertently or inadvertently—material nonpublic information. As of this writing, 95 percent of the American population has been instructed to stay home under various state executive orders and proclamations.<sup>2</sup> Quarantine restrictions also have resulted in many adult children temporarily moving back in with their parents, allowing families to stay together during the pandemic.<sup>3</sup> As a result, business conversations that typically are conducted in a private office setting are now being held in makeshift home offices, sometimes with several family members within earshot. With family members forced to conduct all of their business activities in confined spaces, the opportunities for non-insiders to overhear—and then trade on—confidential corporate information have increased.

Even before the current pandemic, the SEC staff focused on, and filed, civil enforcement actions involving cohabitating individuals who allegedly traded on material nonpublic information overheard from corporate insider family members. In one recent case, a New York-based banking consultant settled insider trading charges with the SEC after trading on material nonpublic information he obtained while eavesdropping on the phone conversations of his then-fiancé, an investment banker, in their shared apartment.<sup>4</sup> Similarly, spouses regularly have been charged with insider trading for trading on material nonpublic information overheard in confined spaces, including in cars during long road trips.<sup>5</sup> The conditions created by the current quarantine restrictions—with business activity being conducted in confined spaces—are ripe for insider trading opportunities and resulting SEC investigations. Moreover, if an insider were to disclose material nonpublic information to a family member in confidence, and the family member were to then trade on that information, the insider would be jointly and severally liable with the individual who made the illegal trade, and also could face additional sanctions.

In addition to fostering unprecedented opportunities for insider trading, the COVID-19 pandemic has created an environment where, unfortunately, individuals may have a heightened motive to benefit from material nonpublic information. As businesses continue to navigate stringent government restrictions—including the mandated closure of many “nonessential” businesses—companies and individuals are feeling the economic strain. Entire industries have been shuttered, and unemployment filings have reached unprecedented levels.<sup>6</sup> Indeed, while the scope of the COVID-19 pandemic's impact on the global economy remains unclear, many portfolios and retirement accounts are likely to be decimated. Given this adverse and uncertain economic environment, the temptation to trade on material nonpublic information may prove particularly strong.

## SEC Insider Trading Investigation and Enforcement

As opportunity and motive for COVID-19-fueled insider trading increases, so too does the risk of government investigations and SEC enforcement actions. On March 23, 2020, Stephanie Avakian and Steven Peikin, Co-Directors of the SEC's Division of Enforcement, issued a statement advising that the Agency will actively pursue COVID-19 related insider trading and anti-fraud violations in light of the unique opportunities the pandemic has created for individuals and companies to profit from material nonpublic information.<sup>7</sup> As a result, companies would be wise to evaluate and reassess their insider trading policies to minimize the likelihood of an ensuing SEC investigation or enforcement action regarding either insider trading itself, or allegedly insufficient insider trading corporate policies.

As noted above, the SEC's Division of Enforcement has indicated increased efforts to maintain market integrity during the pandemic. Specifically, the Agency has noted that its

Enforcement Division is committing substantial resources to ensuring that our Main Street investors are not victims of fraud or illegal practices in these unprecedented market and economic conditions.<sup>8</sup>

The SEC and US Department of Justice (DOJ) already have begun investigating insider trading allegations lodged against Senators Richard Burr, Kelly Loeffler, and others, alleging that these public officials sold millions of dollars in stock just weeks after being privately briefed on the substantial impact the novel coronavirus would have on the economy and the stock market.<sup>9</sup> Accordingly, while the SEC has been sensitive to the needs of public companies during this crisis, offering a filing extension and enhanced disclosure guidance,<sup>10</sup> the risk of being the target of an SEC investigation or enforcement action appears to have increased. Moreover, depending on the nature of the infraction, insider trading could

also expose corporate insiders to a DOJ investigation and potential criminal liability.

It is worth noting, however, that the current quarantine environment may create issues of proof for the SEC and DOJ when investigating or seeking to enforce the securities laws. Many family members who normally live apart have now found themselves residing in the same space, as they ride out quarantine restrictions together. Conversations that otherwise would have occurred by telephone, or via text message, or by email are now taking place face-to-face. Accordingly, there is a heightened risk that material nonpublic corporate information is being disseminated, wittingly or unwittingly, without any data or paper trail. Although insider trading is almost always established through circumstantial evidence, the lack of paper trails associated with potential COVID-19 insider transactions may hinder government efforts to successfully file and prosecute these cases.

## Insider Trading and Section 10(b) Securities Class Actions

Evidence of COVID-19 insider trading can fuel more than government investigations and enforcement actions. It also can help private class action plaintiffs support a case for corporate liability under Section 10(b) of the Securities Exchange Act of 1934. Given the volatility of the current market, we are likely to see an increase in shareholder litigation seeking to recover market losses. Accordingly, companies should be cognizant of the ways in which insider trading allegations may support private claims for Section 10(b) relief.

Parties already have begun to file COVID-19-related securities class actions under Section 10(b) and Rule 10b-5 promulgated thereunder, which prohibit fraud in connection with the purchase or sale of securities. Many of these suits are alleging that corporations violated Rule 10b-5 by making material misstatements or omissions regarding the effect COVID-19 would have on their businesses, thereby artificially inflating the price of the companies' securities and harming investors when the

truth was finally revealed to the market, causing the companies' stocks to drop. For instance, in *Douglas v. Norwegian Cruise Lines Holdings Ltd.*<sup>11</sup> and *Atachbarian v. Norwegian Cruise Lines*,<sup>12</sup> two securities fraud class actions recently filed against defendant Norwegian Cruise Lines, plaintiffs allege that defendant issued false statements about the cruise line's ability to withstand COVID-19, despite being aware that the pandemic would have a detrimental effect on the company's business.<sup>13</sup>

To succeed on a 10b-5 claim, plaintiffs successfully must plead that the individual corporate defendants had scienter—that is, that these defendants knew or recklessly disregarded the risk that the alleged material corporate misstatements or omissions were likely to deceive a reasonable investor. As the US Supreme Court has held, plaintiffs may strengthen an inference of scienter by showing that the individual defendants had motive, such as “personal financial gain,” to commit securities fraud.<sup>14</sup> Plausible allegations of insider trading are one way of pleading motive.<sup>15</sup> Accordingly, given the likely rise in COVID-19-related private securities class actions, companies should be mindful of the ways in which COVID-19 insider transactions may support claims for Section 10(b) liability. Further, insider trading allegations are a common basis for shareholder derivative litigation,<sup>16</sup> which also is expected to increase as companies continue to suffer pandemic-related losses.<sup>17</sup> It is clear that the risks associated with COVID-19 insider trading extend well beyond government investigations and SEC enforcement actions, and should be taken seriously by companies seeking to reduce pandemic-related litigation risk.

### **Best Practices for Limiting the Risk of COVID-19 Insider Trading**

To protect themselves from the threat of an SEC insider trading investigation or enforcement action, companies should take this opportunity to evaluate their internal controls and insider trading policies, and ensure that these policies clearly prohibit trading on material nonpublic information, and adequately

address the increased opportunities for such trading that have been created by the current pandemic. This may mean revising or supplementing corporate policies in light of the company's remote working practices.

Companies also must monitor their employees' compliance with these policies, making sure that all employees are both aware of and abiding by the company's insider trading guidelines. Companies should consider disseminating to their workforce clear advisory communications to remind employees of their obligation to refrain from sharing or trading on material nonpublic information that they learn through their employment. Given the ease with which information may be disseminated among family members in a quarantine environment, company directors, officers, and employees should all be reminded of the substantial risks associated with insider trading, and best practices for protecting confidential information during quarantine. This includes reminding these individuals to ensure that material nonpublic information is only discussed in a private setting, and that computer screens displaying such information are not made visible to non-insiders.

The COVID-19 pandemic inevitably will lead to economic losses, both personal and corporate. Individuals who have access to material information about their own or other companies may not, however, sell stock in these companies to make up for losses without first disclosing this material information to the investing public. To avoid some of the risk associated with nonpublic material information, companies should consider disclosing some of this information in their Forms 8-K, to reduce the chance that the company's material nonpublic information is traded on prior to public disclosure.

Further, when preparing their periodic disclosure documents, companies should review and follow the COVID-19 disclosure guidance recently issued by the SEC's Division of Corporation Finance.<sup>18</sup> This guidance asks firms to evaluate

the effects COVID-19 has had on [the] company, what management expects its future impact to be, how management is

responding to evolving events, and how [the company] is planning for COVID-19-related uncertainties . . . .<sup>19</sup>

Companies therefore should assess carefully the impact COVID-19 and related government restrictions will have on their businesses prior to making their required disclosures, and should remind directors, officers, and employees to refrain from trading on material information prior to these disclosures being made public.

### Notes

1. SEC, Release No. 34-88465, Order Under Section 36 of the Securities Exchange Act of 1934 Modifying Exemptions from the Reporting and Proxy Delivery Requirements for Public Companies (Mar. 25, 2020), <https://www.sec.gov/rules/exorders/2020/34-88465.pdf>.
2. Sarah Mervosh, Denise Lu and Vanessa Swales, “See Which States and Cities Have Told Residents to Stay at Home,” *N.Y. Times*, <https://www.nytimes.com/interactive/2020/us/coronavirus-stay-at-home-order.html> (last updated Apr. 20, 2020).
3. Michael Hollan, “How Parents Can Handle Grown Children Who Returned Home for the Quarantine,” *Fox News* (Apr. 15, 2020), <https://www.foxnews.com/lifestyle/parents-grown-up-kids-home-quarantine>.
4. SEC, Litig. Release No. 24375, SEC Charges Husband of Investment Banker with Insider Trading (Dec. 17, 2018), <https://www.sec.gov/litigation/litreleases/2018/lr24375.htm>.
5. SEC v. Chen, No. 5:14-cv-01467 (N.D. Cal. Apr. 7, 2014).
6. Patricia Cohen and Tiffany Hsu, “‘Sudden Black Hole’ for the Economy with Millions More Unemployed,” *N.Y. Times* (Apr. 9, 2020), <https://www.nytimes.com/2020/04/09/business/economy/unemployment-claim-numbers-coronavirus.html>.
7. Stephanie Avakian and Steven Peikin, Co-Directors, SEC Division of Enforcement, *Statement Regarding Market Integrity* (Mar. 23, 2020), <https://www.sec.gov/biography/steven-peikin>.
8. *Id.*
9. Jack Kelly, “Senators Accused of Insider Trading, Dumping Stocks After Coronavirus Briefing,” *Forbes* (Mar. 20, 2020), <https://www.forbes.com/sites/jackkelly/2020/03/20/senators-accused-of-insider-trading-dumping-stocks-after-coronavirus-briefings/#5aa8e6c4a45d>; Paul Tuchmann, “Insight: Senator’s Insider Trading Allegations Can Be Proved,” *Bloomberg* (Apr. 16, 2020), <https://news.bloomberglaw.com/white-collar-and-criminal-law/insight-senators-insider-trading-allegations-can-be-proved>.
10. See SEC, Division of Corporation Finance, CR Disclosure Guidance: Topic No. 9 (Mar. 25, 2020), <https://www.sec.gov/corpfin/coronavirus-covid-19>.
11. *Douglas v. Norwegian Cruise Lines Holdings Ltd.*, Case No. 1:20-cv-21107 (S.D. Fla. Mar. 2, 2020).
12. *Atachbarian v. Norwegian Cruise Lines*, Case No. 1:20-cv-21386 (S.D. Fla. Mar. 31, 2020).
13. As of this writing, Norwegian Cruise Lines is facing three separate putative 10b-5 class actions related to its COVID-19 disclosures, with a third suit filed on April 22, 2020. See *Banuelos v. Norwegian Cruise Lines*, No. 1:20-cv-21685-JEM (S.D. Fla. Apr. 22, 2020).
14. *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 325 (2007).
15. See, e.g., *In re Hertz Global Holdings, Inc.*, 905 F.3d 106, 119 (3d Cir. 2018) (noting that “[a]lleging insider trading is one way to plead motive”).
16. See, e.g., *In re Oracle Corp. Deriv. Litig.*, 824 A.2d 917 (Del. Ch. 2003).
17. Shareholder plaintiffs already have begun filing pandemic-related derivative actions against public companies. See *Beheshti v. Inovio Pharma, Inc. et al.*, No. 2:20-cv-01962 (E.D. Pa. Apr. 20, 2020) (alleging that officers and directors of Inovio breached their fiduciary duties to the company by issuing false statements concerning the development of a COVID-19 vaccine). This action contains an insider trading allegation, alleging that the individual corporate defendants “breached their fiduciary duties by failing to correct and/or causing the Company to fail to correct these false and misleading statements and omissions of material fact to the investing public, while one of the Individual Defendants engaged in an improper insider sale, netting proceeds of approximately \$63,000.” Complaint at 4–5, *Beheshti v. Inovio Pharma, Inc. et al.*, No. 2:20-cv-01962 (E.D. Pa. Apr. 20, 2020).
18. CR Disclosure Guidance: Topic No. 9, *supra* n.10.
19. *Id.*