

From The Living Room To The Boardroom And Beyond: Insider Trading And Corporate Governance Risks In A Covid-19 World

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What is Insider Trading?

The short answer

The **purchase, sale, or trade of securities** by any person who possesses **material nonpublic information**, generally in breach of a **fiduciary duty** or relationship of trust

Fiduciary duty

“A firm’s confidential information belongs to the firm itself, and an insider entrusted with it has a fiduciary duty to use it only for firm purposes. The insider who personally benefits—*i.e.*, whose purpose is to help himself—from disclosing confidential information therefore breaches that duty; the insider who discloses for a legitimate corporate purpose does not.”

--United States v. Martoma, 894 F.3d 64, 73 (2d Cir. 2018)

What is a security?

Common stock, preferred stock, warrants, convertible debentures, etc.

Derivative securities relating to the company’s stock (i.e. futures, options, swaps, etc.)

What is a purchase, sale, or trade?

“Purchase” and “sale” mean what they say.

“Trade” includes any transaction in the Company’s securities, including gifts and pledges.

What does material mean?

Information about the company is material if it would be expected to affect the investment or voting decisions of a reasonable shareholder or investor

OR

if the disclosure of the information would be expected to significantly alter the total mix of the information in the marketplace about the company

Material (cont'd)

In simple terms, material information is any type of information which could reasonably be expected to affect the market price of the company's securities.

Both positive and negative information may be "**material**"



Examples of material information

Financial performance, especially quarterly and year-end operating results, and significant changes in financial performance or liquidity

Company projections and strategic plans

Potential mergers or acquisitions, the sale of company assets or subsidiaries, or major partnering agreements

New major contracts, orders, suppliers, customers or finance sources, or the loss thereof

Major discoveries or significant changes or developments in products or product lines, research, or technologies

Significant changes or development in supplies or inventory, including significant product defects, recalls, or product returns

Examples of material information

Significant pricing changes

Significant changes in senior management or membership of the board of directors

Actual or threatened major litigation, or the resolution of such litigation

Stock splits, public or private securities/debt offerings, or changes in company dividend policies or amounts

Significant labor disputes or negotiations

Receipt or denial of regulatory approval for products

What does “nonpublic” mean?

Material information is “nonpublic” if it has not been widely disseminated to the general public through a report filed with the SEC, or through major newswire services, national news services, or financial news services.

Companies will often create policies dictating when company inside information is considered “public.” E.g., after the close of trading on the 2nd full trading day following the company’s widespread public release of the information



What is “Tipping?”

“Tipping” is when someone discloses material, non-public information about the company to other people, including family members, so that other people may use it to their advantage in the trading of securities

Both **tippers and **tippees** can be guilty of insider trading

**You can commit insider trading whether or not you ultimately receive any benefit from the trade



Keep Quiet!

Never disclose material nonpublic information about the Company.

Never make recommendations or express opinions about trading in the Company’s securities, other than to tell people not to engage in insider trading!

And definitely do not do so on social media!

Only designated Company spokespersons should release material nonpublic information - they will know how to do so in a manner designed to achieve broad dissemination of the information

What are the Consequences of Insider Trading?

Federal and State Criminal penalties | up to 20 years in prison, up to \$5 million fine for individuals, up to \$25 million for corporations

Civil penalties | disgorge profits made or the loss avoided by the trading, pay civil penalties of up to 3 times the profit made or loss avoided

May face private actions for damages | buyer or seller on other end of trade can sue the insider

Company and supervisors may also face civil or criminal penalties

May face company discipline, including termination for cause

Well Known Insider Trading Cases

Ivan Boesky

Got rich by purporting to pick out potential takeover targets and invest before an offer was made. When the offer came, the target firm's stock would shoot up, and Boesky would sell his shares for a profit.

Sometimes Boesky would buy mere days before an unsolicited bid was made public - suspicious.

Boesky's "talent" turned out to be a fraud - he was secretly paying bankers in the M & A arms of major investment banks to get tips on pre-takeover information.

When Boesky hit home runs on nearly every major takeover deal in the 1980s (Getty Oil, Nabisco, Gulf Oil, Chevron, Texaco), the SEC became suspicious.

The SEC's break came when Merrill Lynch was tipped off that someone in the firm was leaking info - the SEC caught the Merrill Lynch employee, who gave up Boesky

R. Foster Winans - WSJ Columnist

Winans wrote the "Heard on the Street" column of the WSJ, which would profile a certain stock. The stocks featured often went up or down according to Winans' opinion.

WSJ had a policy which stated that before publication, the contents of its columns were the Journal's confidential information. Winans leaked the contents of his column to a group of stockbrokers, who used the tips to take positions on the stock before the column was published. The brokers shared their profits with Winans.

The courts ruled that the info in the column belonged to the WSJ, not Winans, and found him guilty of several types of fraud, including securities fraud.

Martha Stewart

In December 2001, the FDA announced that it was rejecting a new cancer drug that manufacturer ImClone was attempting to put out to market. As the drug represented a major portion of ImClone's pipeline, the company's stock sharply declined in value.

Many pharmaceutical investors were affected by the drop, but the family and friends of ImClone's CEO were not - turns out he had tipped them off.

Martha Stewart's stockbroker was also the stockbroker to the CEO of ImClone, saw that the CEO and his family were selling off large portions of their ImClone stock, and tipped Martha Stewart that she should sell her ImClone stock.

The case was complicated for a variety of legal reasons, but Stewart and her stock broker ended up getting convicted for telling a series of lies to cover the facts surrounding her trade -- > ultimately convicted of obstruction of justice and conspiracy, not insider trading.

US Senators??

Much in the news recently about U.S. senators who unloaded millions of dollars in stock shortly before the record-breaking market declines spawned by COVID-19.

Sens. Richard Burr (R-N.C.), Kelly Loeffler (R.-Ga.), James Inhofe (R.-Okla.) and Dianne Feinstein (D. - Calif.) were privy to closed-door government briefings about the pandemic and unloaded stock ahead of market declines.

Congress members are not exempt from insider trading laws.

Defenses?

- Trading was done pursuant to a 10b5-1 plan
- The information discussed in closed-door briefings was public, or mirrored information already in the public domain
- Speech & Debate Clause of the Constitution prevents the government from using information a Congress member acquired in a committee hearing to prosecute that member (but can still use Congress members statements to broker, for example)

Examples of SEC Insider Trading Actions

Two business associates charged after one learned nonpublic information while serving on the board of directors of a pharmaceutical company, and both traded on the info

Former CEO and close friend charged after CEO tipped friend with confidential details about his company's non-public merger discussions

Hedge fund analyst and roommate charged with insider trading ahead of an announcement that hedge fund had taken a \$1 billion short position in a company

Attorney and his wife charged with insider trading based on confidential information the attorney learned from a corporate client

Financial analyst at pharmaceutical company charged with tipping off friend about potential acquisition targets of company

Examples (cont'd)

IT professional at a law firm charged after learning about several mergers and acquisitions involving firm clients and trading on the information

Clinical drug trial doctors charged after trading on insider knowledge that FDA had halted clinical trials of a new prostate cancer drug.

Two husbands charged with trading on insider information they learned from their wives about Silicon Valley-based tech companies.

Group of golfing friends charged after trading on inside information learned from an executive who belonged to the same country club.

Former BP employee charged with illegally selling his family's BP securities after receiving confidential information about the severity of the spill that the public didn't know.

What's a Company to do? Suspension of all Trading Activities

From time to time, the Company may impose a "blackout" period during which some or all of the Company's employees may not buy or sell Company securities.

The Compliance Officer will impose such a blackout period if, in her judgment, there exists nonpublic information that would make trades by the Company's employees inappropriate in light of the risk that such trades could be viewed as violating applicable securities laws.

What's a Company to do? Responsibilities of Employees

Employees may, from time to time, have to forego a proposed transaction in the Company's securities even if she planned to make the transaction before learning of the material nonpublic information, and even though the employee believes that she may suffer an economic loss or forego anticipated profit by waiting.



Special Rules for Section 16 “Insiders”

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Special restrictions apply to transactions in Company securities by “Insiders”

Who are Section 16 “Insiders?”

- Directors
- Executive officers (typically, president, principal financial officer, principal accounting officer or controller, any vice president in charge of a principal business unit, division, or function, or any other officer or person who performs a policy-making function)
- Greater-than-10% stockholders

Other designated “insiders” are people who are regularly in possession of material, non-public information or who perform an operational role that is material to the Company as a whole

Section 16 Insiders’ trades are subject to reporting to the SEC on Form 4

Insiders - cont'd

Insiders allowed to trade only during open “trading windows”

***Even when trading window is open, Insiders and other Company personnel are prohibited from trading in the Company’s securities while in possession of material nonpublic information

Insiders must report the details of each transaction in Company stock immediately after it is executed

Insiders cont'd - Hardship Exemption

What's an Insider to do?

- **Hardship exemption:** can request permission to trade Company’s securities outside of the trading window due to financial or other hardship
 - But Insider still may not trade, even if experiencing hardship, while possessing material nonpublic information concerning the Company

Insiders cont'd - Blackout Periods

- Company may impose special blackout periods due to existence of material nonpublic information, such as a pending acquisition, that is likely to be widely known among Insiders.
- During any blackout period, Insiders are prohibited from trading in shares of Company stock
- No hardship exemption available

Insiders cont'd - Pre-Clearance of Trades

- Typically, all purchase and sales of equity securities of the Company by Insiders, other than those made pursuant to a 10b5-1 trading plan approved by the Board of Directors, must be pre-cleared by the Company's Compliance Officer
- **Intent:** to prevent inadvertent violations of the Insider Trading Policy, avoid trades that involve the appearance of insider trading, and facilitate the Company's timely Form 4 reporting

Insiders cont'd - 10b5-1 Trading Plans

Insiders can establish documented 10b5-1 trading plans, which can help insulate from insider trading liability

- **10b5-1 trading plans typically:**

1. Specify the amount of securities to be purchased or sold and the price at which and the date on which the securities were to be purchased or sold; or
2. Include a written formula or algorithm, or computer program, for determining the amount of securities to be purchased or sold and the price at which and the date on which the securities were to be purchased or sold; or
3. Did not permit the person to exercise any subsequent influence over how, when, or whether to effect purchases or sales; provided, in addition, that any other person who, pursuant to the contract, instruction, or plan, did exercise such influence must not have been aware of the material nonpublic information when doing so

Example: on the 15th day of every month, Insider A will sell 100 shares of Company stock for \$100 per share

Insiders cont'd - 10b5-1 Trading plans

10b5-1 trading plans must be pre-cleared with the Company

- not all plans will be automatically approved

10b5-1 trading plans must be established at a time when the trading window is open

Trades executed under 10b5-1 plans must be reported to the Company, who must report them on Form 4

Insiders cont'd - 10b5-1 Trading Plans

10b5-1 plans are not get out jail free cards!

The SEC will look into abuses of Rule 10b5-1 trading plans, and has focused particularly on modifications and terminations of plans and on questioning whether holders of plans truly did not know market-moving information when they prearranged trades under the plan.

In June 2009, the SEC charged the former CEO of Countrywide Financial, Angelo Mozilo, with insider trading. The SEC alleged that he "established four executive stock sale plans for himself in October, November, and December 2006 while he was aware of material, non-public information concerning Countrywide's increasing credit risk and the expected poor performance of Countrywide-originated loans." He then later exercised options and sold company stock under these written trading plans.

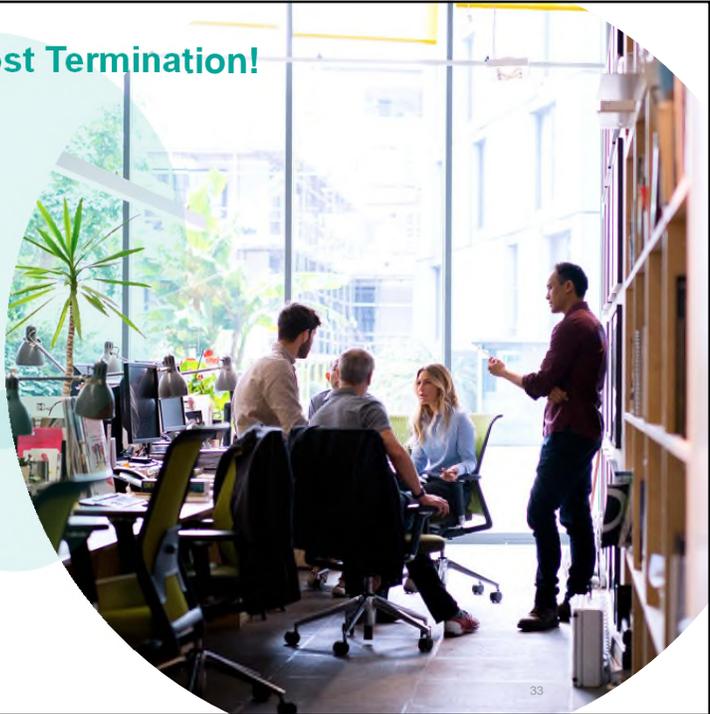
Eventually, in October 2010, Mr. Mozilo agreed to pay the largest-ever SEC penalty by a public company executive, along with a \$45 million disgorgement of ill-gotten gains to settle the disclosure violation and the insider-trading charges.

Insiders cont'd - Designated Brokers

- Insiders and their families who transact in Company stock must generally use a broker designated by the Company, unless have received permission to use another
- That broker immediately reports to the Company the details of all transactions in Company equity securities, agrees not to execute any transactions for the Insider or their family until the broker has verified with the company that the transaction has been pre-cleared, and the broker agrees to immediately report the transaction details directly to the Company and Insider

Insider Trading Rules Apply Post Termination!

If an employee is in possession of material nonpublic information when her employment terminates, she may not trade in the Company's securities until that information has become public or is no longer material



Companies Should Make Reporting Duties Applicable to Everyone

Companies should consider requiring any person who engages in insider trading, or violates insider trading policies, **or knows of anyone who violates the policy**, to report the violation immediately to the Compliance Office or Audit Committee of the Company's Board of Directors

**Company may respond by releasing material nonpublic information, and/or by self-reporting to the SEC or other governmental authority



Insider Trading Risks During a Pandemic

Why are insider trading risks heightened during a pandemic?

- World in chaos: Global recession, extra volatile markets
- Company in chaos: Reduced demand, supply chains in disruption, Company financial results in turmoil
- General panic mindset
- More people having access to MNPI, including those who are not used to hearing it or handling it
- Remote work environment - risk of people feeling too comfortable, like workplace “rules” are not in place
- Family members constantly within earshot,
- MNPI spread out across kitchen table

The SEC is Watching Now More than Ever!

The SEC has warned public companies to be mindful of their obligations not to trade on material non-public information during the pandemic.

<https://www.sec.gov/corpfin/coronavirus-covid-19>

This means that where COVID-19 has affected a company in a way that would be material to investors, or where a company has learned of a COVID-19-related *risk* that would be material to investors, the company, its directors and officers, and other corporate insiders and employees who are aware of the information should refrain from trading in the company’s securities until the information is properly disclosed to the public.

Examples of COVID 19-Related MNPI

- Plans to materially downsize the Company, or issue pay cuts;
- The impending bankruptcy of another player in the Company's supply chain (e.g., the Company's main supplier or customer);
- A pending announcement that the Company will begin manufacturing PPE;
- Information about the Company's PPE loan application (i.e. the Company will be repaying the loan, the Company is under investigation for the way it filled out the loan application, etc.);
- Information about the spread of Covid-19 in the Company's headquarters and the resulting imposition of lengthier work from home requirements.

What Can Companies Do To Mitigate the Risk of Insider Trading During a Pandemic?

- Refresh insider trading policies and trainings in order to remind all employees—and particularly insiders—of their legal duties.
- Remember that MNPI can be information learned not only about your company, but about other companies you work with
- Revisit who is designated as an "insider," and consider expanding the list to include individuals responsible for managing COVID-19-related issues.
- Relatedly, consider re-designating who is subject to blackout and pre-clearance procedures
- Tighten information disclosure policies so that material bits of information are not selectively leaked.
- Be wary of requests to change 10b5-1 trading plans, or to create new 10b5-1 plans, as such movements could be viewed as attempts to provide "cover" for insider trading activities.
- Exercise good cyber-hygiene: work closely with IT staff to tighten firewalls, double-down on protections against hacking etc. so that MNPI is not used by hackers to trade
- Work closely with outside counsel to determine whether information might be considered material to an investment decision and whether (and to what extent) the company is obligated to publicly disclose the information.
- Retain separate counsel for individuals who come under scrutiny for insider trading - their interests may not align with the company's interests

Fiduciary duties - reviewing the basics

- Fundamental principle of corporate law:
 - “The business and affairs of every corporation... shall be managed by or under the direction of a board of directors...” (DGCL, Section 141(a))
- The board discharges its duties by appointing and supervising officers who run the day to day operations
- Officers are subject to the same duties as directors

Fiduciary duties

There are two core fiduciary duties:

The duty
of care

The duty
of loyalty

Directors owe these duties to the stockholders of the corporation as a whole, not just to a certain group.

See, e.g., In re Trados Inc. Shareholder Litigation ("Trados II"), 73 A.3d 17, 39 (Del. Ch. 2013).

Duty of Care

Legal definition:

Under Delaware law the **duty of care** requires that directors discharge their duty above:

1. In good faith
2. With the amount of care which an ordinarily careful and prudent person would use in similar circumstances
3. In a manner the director reasonably believes to be in the best interests of the corporation

Duty of Care (cont'd): Possible Breach

- Where the director takes no action in a situation where a careful person would have taken action. In re Caremark International Inc. Derivative Litigation, 698 A.2d 959 (Del. Ch. 1996).
- Recent years have been marked by an increasing focus on compliance oversight.



Duty of Care (cont'd): Possible Breach

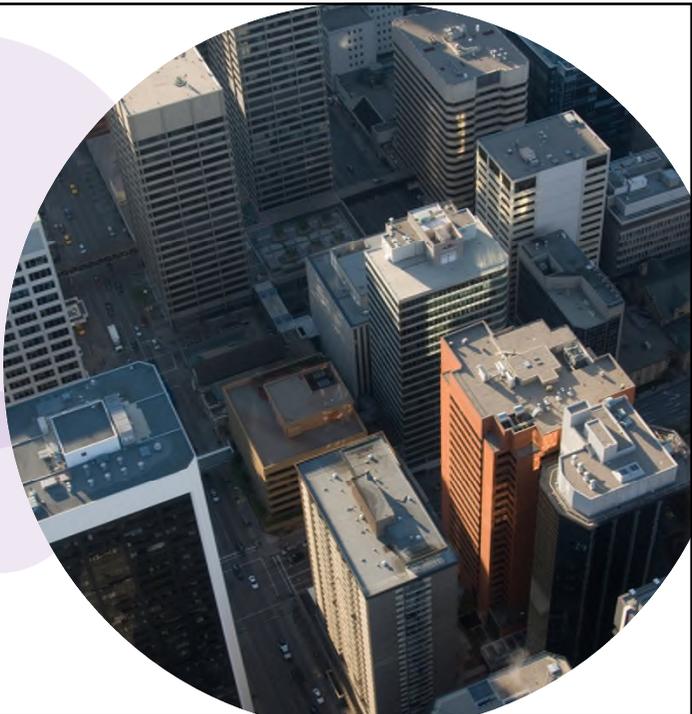
- US Foreign Corrupt Practices Act (FCPA)
 - “Under the US Sentencing Guidelines, the Board must exercise reasonable oversight on the effectiveness of a company’s compliance program.”
 - The US Department of Justice (DOJ) Prosecution Standards posed the following queries:
(1) Do the Directors exercise independent review of a company’s compliance program and (2) Are Directors provided information sufficient to enable the exercise of independent judgment?



Duty of Care (cont'd):

Other compliance related examples:

- Antitrust and competition laws
 - Section 8 of the Clayton Act prohibits interlocks between competitors:
serving on board seats of competitors
 - Avoid coordination of competitor’s activities through a common board member or officer
- Avoid any instance of serving on the Boards or executive teams of competitors



Duty of Care (cont'd):

Additional Considerations:

- Non-Delegation: The duty of care cannot be delegated to other decision-makers
- Recordkeeping: Establish an adequate record of the entire decision-making process



Duty of Loyalty

Definition: The duty to act in the best interest of the corporation and its stockholders by not putting any personal interest ahead of the interests of the corporation or its stockholders.

Examples:

- Directors stand on both sides of a transaction or otherwise receive a benefit (an “interested” director);
- Directors are beholden to a party with an interest (a “non-independent” director)

Judicial Review Standard: Business Judgment Rule

- Delaware courts recognize that directors sometimes must take business risks to promote the best interests of the corporation and its stockholders
- To this end, Delaware and other US jurisdictions have adopted a form of the **business judgment rule**
- Satisfied directors are not personally liable, and a corporate action will not be overturned

The Business Judgment Rule & Duty of Care

In a lawsuit alleging a breach of the duty of care, the court presumes directors exercised proper business judgment unless plaintiff shows directors did not meet these **three elements**:

1. **Informed** about the corporation and its decisions and is required to participate in board actions. Recall reliance on others is permitted
2. **Good faith.** The decision-making process must be substantive and cannot just rubber-stamp management's actions
3. **Best interest of the corporation.** The directors also must reasonably believe the action or transaction was made in the best interest of the corporation

If the plaintiff can prove the directors did not meet **any of the above elements**, then the burden of proof shifts to the directors to prove the action or transaction was **entirely fair to the corporation = fair price and fair dealing**).

Duty of Loyalty: No BJR if Conflict of Interest

- No business judgment rule if conflict of interest
- However, if **any one of the three conditions** applies, then the corporate decision stands:
 1. Disclosure and approval in good faith by a **majority of the disinterested directors.**
 2. Disclosure approval by **stockholders OR**
 3. The **transaction is fair** to the corporation at the time it is approved or ratified by the board of directors or the stockholders
- To avoid the need to prove a transaction is fair, a director should always disclose in writing any conflict of interest and get the approval of the disinterested directors or the stockholders if possible



Duty of Good Faith & Duty to Obey the Law

- **Duty of Good Faith:** The duty of good faith, sometimes recognized as a separate duty, is also a component of the duty of care and the duty of loyalty
- **Duty to Obey the Law:** Directors have a duty to comply with the law. If a director **knowingly breaks the law**, the director is denied the protection of the business judgment rule and cannot benefit from limited liability under the corporate statutes



Duty of Good Faith & Duty to Obey the Law

- **Duty to Communicate:** Directors also have fiduciary duty to communicate honestly with the stockholders and to make full and fair disclosures when the Board of Directors is requesting stockholder approvals. Subject to the need of the corporation to keep trade secrets and certain other information regarding its business and technologies confidential



COVID 19 - setting the stage

- COVID 19 it has added another layer of complexity boards when fulfilling their duties
- The board's role remains one of oversight, which requires monitoring management activity, assessing whether management is taking appropriate action and providing additional guidance and direction to the extent that the board determines is prudent
- Boards of directors should be familiar with the management's response to the pandemic, including the major elements of the "reopening plan" developed and executed by management
- A new set of law and regulations puts renewed emphasis on the oversight of compliance programs.

Employee, Customer and Supplier Health and Safety

- Increased focus on the safety and well-being of its personnel and, where applicable, customers and suppliers.
- Consider when, how and at what pace to bring employees back into the workplace
- Balance permitting work from home, where possible, even after government regulations allow non-essential businesses to bring back employees
- Consider how to mitigate the economic impact of absences due to illness as well as closures of certain operations on employees

Operational and Risk Oversight

- Identify the major COVID 19 related risks to the business and its operations
- Consider need for more regular updates from management in between regular board meetings
 - Schedule ahead of time and cancel if not needed
 - Executive sessions to assess how management is performing
- Document consideration of, and decisions regarding, COVID-19-related matters in board meeting minutes
- Discuss potentially increased vulnerability to cybersecurity breaches during the time of the COVID 19 crisis

Risk Oversight: Regulatory Compliance

The pandemic necessitated responses at all levels of government in all countries around the globe. As a result:

- Compliance is a multistate and possibly global issue
- Ensure compliance and oversight policies include new pandemic driven requirements
- Develop process to update policies regularly to ensure ongoing compliance
- Discuss how to prepare management for a potential increase in regulatory scrutiny



Risk Oversight: Liquidity and Scenario Analysis

- Evaluate near-term and longer term financial impact (including the ability to meet obligations) of the COVID-19
- Assess different strategies for preserving liquidity
- Consider strategies for enhancing financial stability and to review contingency plans for addressing potential shortfalls in a variety of scenarios



Risk Oversight: Liquidity and Scenario Analysis (cont'd):

- Consider need for additional capital, sources for capital as well as related government programs
- Review management developed scenarios taking into account different assumptions in terms of duration and impact on the Company
- Review the plans for operating in the face of an ongoing pandemic



Risk Oversight: Business Continuity

- Review or discuss elements of a business continuity plan
- Elements to consider:
 - Impact on human capital and related contingency plans, including key person succession planning
 - Supply chain management and review of related contractual obligations (force majeure, termination, events of default)
 - Internal Controls and Audit Function are the reporting, auditing and review processes are sufficiently robust



Risk Oversight: Crisis management

- Cross-Functional Crisis Response Team
 - key individuals from management, PR, HR, legal and finance
 - Regular communication with the board
- Communication strategy and procedures
- Contingency planning to eliminate under- or over-reacting



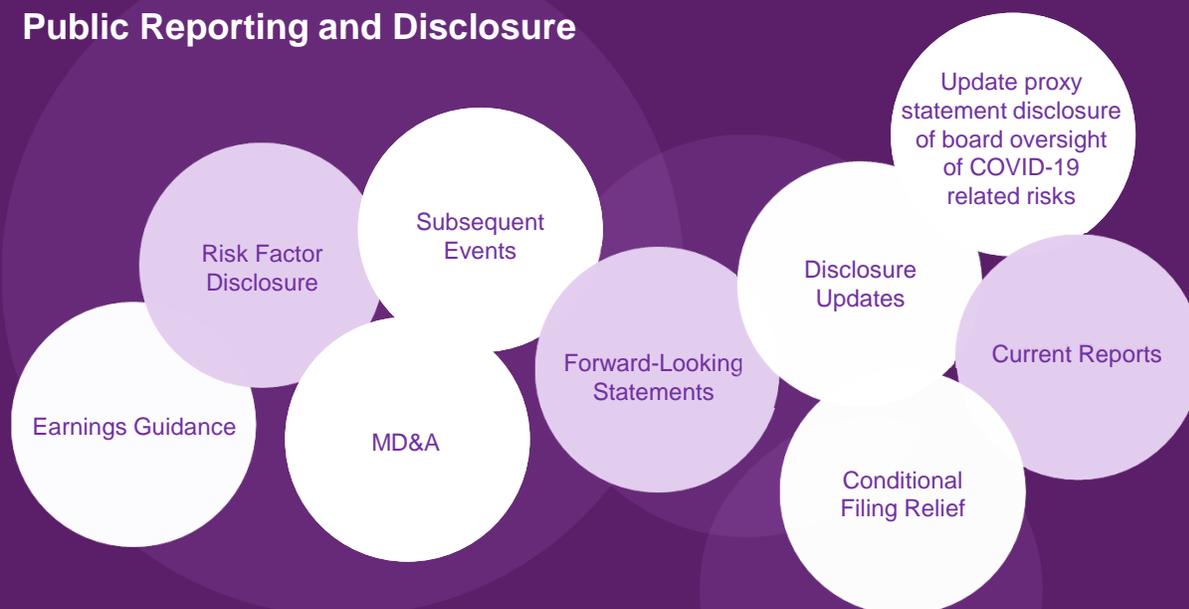
Strategic Planning beyond COVID 19

- Discuss and adjust existing medium- and long-term goals
- Consider medium- and long-term impact of short-term decisions taken in the face of the pandemic
- Balance short term and long term outcomes
- Reassess long term goals in light of challenges and opportunities

Revisiting ESG, Culture and Purpose

- Continue to identify the ESG risks to and formulate long-term responses
- Diversity and human capital management issues bear unique challenges during the pandemic
- Boards should consider management's response to limit a possibly disproportionate impact of COVID 19 on a variety of stakeholders
- The pandemic provides a unique opportunity to reassess a company's culture and purpose and where the pandemic cause fissures
- Reiterate culture and purpose of the company from the top driving strategies to improve from the top down to reach better performance

Public Reporting and Disclosure



Other Public Company issues



Thank you



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