LOS ANGELES & SAN FRANCISCO
Daily Journal
www.dailyjournal.com
WEDNESDAY, APRIL 1, 2020

PERSPECTIVE

Insider trading and COVID-19

By Nicolas Morgan, Thomas Zaccaro and Alycia Tulloch

While investigating and prosecuting insider trading violations is a fixture of SEC enforcement activity, enforcement actions against public officials, such as senators, are significantly less common than enforcement against private executives. But with stocks tumbling as a result of the ongoing COVID-19 global pandemic, recent trading activity by several senators seems to have attracted the attention of the SEC and the Department of Justice. On March 23, the SEC released a public statement, serving as a stern warning against trading on nonpublic information related to coronavirus:

"[I]n these dynamic circumstances, corporate insiders are regularly learning new material nonpublic information that may hold an even greater value than under normal circumstances. This may particularly be the case if earnings reports or required SEC disclosure filings are delayed due to COVID-19. Given these unique circumstances, a greater number of people may have access to material nonpublic information than in less challenging times. Those with such access — including, for example, directors, officers, employees, and consultants and other outside professionals — should be mindful of their obligations to keep this information confidential and to comply with the prohibitions on illegal securities trading."

The SEC also noted that the Enforcement Division is committing "substantial resources" to curtail fraud or other illegal trading activity "in these unprecedented market and economic conditions." While Monday's warning came just days after news broke of recent trades by several members of Congress following a private, all-senators briefing on the virus outbreak from Trump administration officials on Jan. 24, SEC Enforcement directed its statement to "corporate insiders," highlighting the broader risk of insider trading liability exposure.

Members of Congress have never been exempt from insider trading laws, but in 2012, President Barack Obama enacted the Stop Trading on Congressional Knowledge Act as an "affirmation of non-exemption." The STOCK Act makes clear that Rule 10b5-1 under the Exchange Act — which prohibits the purchase or sale of a security "on the basis" of material, nonpublic information — applies to members and employees of Congress, as well as to all employees in the executive and judicial branches of the federal government. The "on the basis" standard is the same standard the SEC applies more generally, so the current issue is relevant to all market participants.

There is no doubt that, during a time of acute national unease, unprecedented levels of media attention, and heightened SEC enforcement, the stakes are high indeed.

Legal issues for the senators who sold in February are already mounting. Sen. Richard Burr (one of the senators who sold stock in February) announced that he was contacted by the FBI concerning his February trades. And, on March 23, Burr was sued by a shareholder of Wyndham Hotels & Resorts Inc., one of the stocks that the senator sold. *Jacobson v. Burr*, Case No. 1:20-cv-00799 (D.D.C). The suit alleges that Burr sold his Wyndham shares after receiving confidential congressional briefings concerning the potential "devastating impact" of COVID-19 on the United States. According to the complaint, Wyndham's stock price declined by nearly two-thirds after the sale. The plaintiff, alleging that he "maintained his stock holdings in Wyndham at artificially inflated prices," purports to assert claims under the STOCK Act and Sections 10(b) and 20A of the Exchange Act, and Rule 10b-5. Although a holder claim brought by a shareholder who neither bought nor sold securities likely will not be successful, another shareholder who purchased Wyndham shares contemporaneously with Burr's sale could have more success.

In response to public scrutiny, Burr and other members of Congress who sold stock after congressional COVID-19 briefings have been adamant that they have acted lawfully, making decisions to trade solely in reliance on publicly available news reports, despite their access to classified (i.e., nonpublic) material information. They also have claimed that their investments are held in blind trusts that eliminate their ability to make discretionary investment decisions. Their statements raise questions about causation and the "use" of material, nonpublic information in trading. How should the SEC and the courts handle cases involving individuals with both lawful and unlawful reasons for trading? When an individual with access to both public (lawful) and nonpublic (unlawful) information engages in trading, should the law disregard the lawful trading rationales, such as news reports, or focus instead on the individual's access to nonpublic information, despite the existence of a lawful and independent basis for trading?

For decades, courts have addressed this conundrum in a variety of ways, resulting in a prominent circuit split in the 1990s regarding the "use" of material, nonpublic information in trading. *See United States v. Smith*, 155 F.3d 1051 (9th Cir. 1998); *United States v. Teicher*, 987 F.2d 112 (2d Cir. 1993); *SEC v. Adler*, 137 F.3d 1325 (11th Cir. 1998). The SEC attempted to resolve this issue through rulemaking in 2000 with the adoption of Rule 10b5-1, which codifies the SEC's position that trades are made "on the basis" of material, nonpublic information when the person making the purchase or sale was aware of material, nonpublic information when the trade was made. Thus, the SEC takes the position that it need not prove a trader "used" the material, nonpublic information to trade. As part of the rule, the SEC also included an affirmative defense to shield those with knowledge of material, nonpublic information from liability for conducting certain trades "if the person making the purchase or sale demonstrates that [b]efore becoming aware of the information, the person had ... adopted a written plan for trading securities."

While the SEC's position is clear, future defendants may challenge the SEC's interpretation of the securities laws and the courts' deference to those interpretations. *See Whitman v. United States*, 574 U.S. 1003 (2014) (No. 14-29, Nov. 10, 2014) (statement issued by Justices Antonin Scalia and Clarence Thomas in connection with court's denial of certiorari in criminal insider trading case criticizing the 2nd U.S. Circuit Court of Appeals' deference to SEC's interpretation of Section 10(b) as reflected in Rule 10b5-1 regarding use of material, nonpublic information).

The recent controversial trades by trusted members of Congress bring light to this old issue. There is no doubt that, during a time of acute national unease, unprecedented levels of media attention, and heightened SEC enforcement, the stakes are high indeed. As outlined above, market participants in possession of material, nonpublic information should be cautious about trading that could later be construed by regulators as having been made "on the basis" of said information. ■

Nicolas Morgan *and* **Thomas A. Zaccaro** *are partners at Paul Hastings LLP in Los Angeles. Morgan previously served as senior trial counsel in the SEC's Enforcement Division. Zaccaro previously served as the chief trial counsel of the SEC's Pacific Regional Office.* **Alycia Tulloch** *is a law clerk with the firm.*