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White Collar Enforcement During the Coronavirus Crisis

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The COVID-19 pandemic has caused the dislocation of the world's financial markets. Equity markets in the United States have been incredibly volatile and at one point, had lost more than 30 percent of their value. Local and national policies in response to the pandemic are changing constantly, with dramatic impacts on businesses of all sizes. At the moment, no one knows what the total impact will be or when the situation will start to turn around for the better.

Historically, the Securities Exchange Commission (SEC) and the Department of Justice (DOJ) have become very active in the aftermath of severe market dislocations, both to enforce existing law and to make examples out of those who—at least in the government's eyes—took unfair advantage of the chaos. Following the 2008 financial crisis, for example, the SEC instituted proceedings against more than 200 entities and individuals, including 93 CEOs, CFOs and other senior corporate officials, collecting nearly \$4 billion in penalties, disgorgement, and other monetary relief.¹

The market volatility we are experiencing now during the coronavirus crisis very likely will cause the government to initiate numerous investigations. The Attorney General has directed all US Attorneys

“to prioritize the detection, investigation, and prosecution of all criminal conduct related to the current pandemic,” considering it “essential that the Department of Justice remain vigilant.”² In this regard, the government likely will employ a variety of statutes and theories to prosecute abuses in the securities markets and everywhere else that scams and schemes emerge.

Insider Trading

After the 2008 financial crisis, the government closely examined trading activity and aggressively pursued conduct it suspected to be insider trading. The DOJ instituted the most wide-ranging series of insider trading prosecutions in history after the 2008 financial crisis to hold many companies, and importantly, individuals accountable. In these matters, the government sought ill-gotten gains, penalties and to impose significant prison sentences.³

In response to the current crisis, the co-directors of the SEC Division of Enforcement warned that “a greater number of people may have access to material nonpublic information than in less challenging times,” increasing the potential for insider trading.⁴

Four aspects of insider trading law will be key to the coming investigations.

1. *The government is likely to rely on Rule 10b5-1.* Generally, for a transaction to constitute insider trading under Rule 10b5-1, the person must make the trade “on the basis of” material nonpublic information. Rule 10b5-1 defines this phrase to include merely being “aware” of material nonpublic information at the time of the trade, even if the information was not the only reason for the trade. Although there is a circuit split as to whether the Rule applies to insider trading prosecutions,⁵ the language of this Rule allows the SEC, at the very least, to bring a civil action against any person or firm who traded while in possession of material nonpublic information, regardless of any separate motivation they may have had for their trades.⁶
2. *The government will thoroughly pursue downstream tipping.* Under Section 10(b) and Rule 10b-5, the source and the ultimate recipient of material nonpublic information can be liable as “tipper” and “tippee” assuming the appropriate elements are met. Liability attaches where the tipper breached a duty of trust or confidentiality in divulging the information and received a “personal benefit” for doing so.⁷ Given how quickly new, material information is developing in the current volatile market, the government can be expected to scrutinize closely whether information that ultimately results in well-timed trades emanates from persons who owe a duty of trust or confidentiality.
3. *The government may return to investigating material nonpublic information flowing through expert networks.* Of particular note here is the use of political intelligence, which requires exceptional diligence and care to ensure that any information one possesses relevant to a trade was properly obtained.⁸ In fact, in the prosecution that led to the Second Circuit’s recent decision in *United States v. Blaszczak*, it was governmental information regarding proposed healthcare rules and reimbursement rates that was held to constitute material nonpublic information.⁹
4. *As in Blaszczak, the government will likely use 18 U.S.C. § 1348, a criminal statute created by the Sarbanes-Oxley Act of 2002, as a further tool in pursuing downstream tippees and others who trade on material nonpublic information.* This statute criminalizes a wide range of fraudulent practices connected with securities and commodities. Importantly, unlike Section 10(b), the Second Circuit held in *Blaszczak* that Section 1348 does not require any showing that the tipper received a “personal benefit” from passing along the information for criminal liability to attach.¹⁰ Thus, while this statute only applies to trading in registered securities, which is a narrower focus than Section 10(b), prosecution under Section 1348 may relieve the government of proving one of the typical elements of insider trading.¹¹

Disclosure

With conditions changing so rapidly, the government likely will scrutinize the accuracy of oral and written statements at the time they were made. The SEC has identified disclosure as a major area of focus for 2020.¹² SEC Chairman Jay Clayton recently advised companies to “provide investors with insight regarding their assessment of, and plans for addressing, material risks to their business and operations resulting from the coronavirus.”¹³ Information about how the pandemic is affecting a company’s operations, cash flow, asset values and customer behavior is likely of key interest to the investing public. The government will pay careful attention to the ultimate accuracy of the financial information itself as well as any statements about how the company plans to respond to the pandemic and its goals going forward.

Compliance with generally accepted accounting practices (GAAP) has always been an area of focus for the SEC. But these investigations are not just limited to whether the financial statements comport with GAAP, but whether *what the company says about*

its compliance with GAAP is accurate. In the current crisis, issuers need to analyze the extent of the impacts of coronavirus on their supply chain, communication and other internal controls to determine how the crisis affects their ability to apply GAAP.

Although, as a general rule, companies are supposed to avoid burying the public in an avalanche of trivial detail,¹⁴ a duty to disclose may arise when previous statements are no longer accurate or may have been rendered misleading in light of later developments, necessitating the issuance of an updated, correct statement.¹⁵ Maintaining this balance will be especially important, and subject to government review, during this time.

Another likely pitfall in this fast-changing environment is selective disclosure, where updates reach some parties sooner than the market at large. Regulation Fair Disclosure (Reg FD) generally requires public companies to disclose material non-public information to the public at the same time as or before disclosing the information selectively, such as to analysts, institutional shareholders or other securities industry professionals. Principals, officers and directors fielding requests for up-to-date information must therefore be especially careful to speak accurately and keep the public properly informed.¹⁶

Market Manipulation

The government has a strong interest in maintaining the integrity of the markets and policing any conduct that alters prices or that creates some false appearance of supply, volume or demand to someone's unfair advantage. For example, the government frequently uses this theory to prosecute "pump and dump" schemes in which sellers go to extensive efforts to advertise a particular stock while acquiring it cheaply, only to rapidly sell off their shares when the price swings upwards.

The SEC already has suspended trading for two issuers and continues to monitor the market closely.¹⁷ The government may investigate trading practices it believes unfairly take advantage of volatility, which could sweep in a wide swath of market participants

who were simply reacting to the volatility and trying to do what they could to generate some liquidity or profit for themselves.

Schemes

In times of stress, existing Ponzi schemes and pyramid schemes often unravel as they can no longer support their regular payment obligations. Infamously, Bernard Madoff's Ponzi scheme collapsed during the financial crisis. Already this Spring, the SEC and DOJ put an end to a Ponzi scheme allegedly perpetrated by a Pennsylvania lawyer.¹⁸

By the same token, however, many fraudulent schemes are only getting started during the crisis, taking advantage of people and companies who are increasingly desperate for promises of cash or investments that appear stronger than the volatile stock market.

As more businesses struggle for liquidity to continue or salvage their operations, they may fail to provide accurate financial information when they apply for financing or other liquidity, and fall subject to government enforcement for bank fraud. The same challenge of keeping financial information accurate can also lead to accounting fraud or tax fraud issues when the mismatch between the financial statements and reality is revealed.

Scams

Scams emerging during the coronavirus crisis—and the government's desire to shut them down and punish those responsible—are not limited to the financial markets.¹⁹

Price gouging emerged as a major phenomenon as the coronavirus appeared in the United States, as prices for high-demand items reached multiples of their normal rates on online shopping platforms. Although many platforms have taken action to cut down on these listings, the issue is likely far from resolved. In response, President Trump recently signed an Executive Order and the Attorney General announced an initiative to tackle price gouging and hoarding of medical supplies.²⁰ Nonetheless, as

the shelves of local stores increasingly lay bare and health authorities advise minimizing contact with others, online shopping platforms may face antitrust enforcement inquiries if they misuse their market power or conspire with the gouging sellers.

The Antitrust Division, which already had been very active in the financial services arena,²¹ is getting ready to handle this expected influx of cases. In late February, it requested funding to hire 55 additional attorneys for fiscal year 2021.²² The Attorney General has asked the public to be on the lookout for coronavirus fraud and set priorities for antitrust enforcement.²³

On online platforms and elsewhere, counterfeit goods are increasingly entering the marketplace, seeking to profit by meeting the extreme demand for particular items even when the product itself does not meet the stated specifications. This is particularly concerning when it comes to protective measures the public is relying on to stem the pandemic, like masks for health professionals and hand sanitizer. Alarming, purported coronavirus cures are on sale, none of which have received approval; some of these may well be unsafe to take, and all are unsafe to the extent they do nothing to limit the spread of the virus. The US Attorney's Office for the Western District of Texas acted quickly, obtaining an injunction to shut down a website promising a vaccine in exchange for credit card information to cover purported shipping charges.²⁴

There already has been a marked increase in cybercrime, involving fake maps of the spread of the virus, malicious links purporting to provide important public safety announcements and phishing attempts hoping to take advantage of workforces continuing their daily tasks from home.²⁵ There will be significant prosecution activity under the Computer Fraud and Abuse Act and other statutes for this conduct.²⁶

Several scams target older individuals and those who care for them, taking advantage of their fear of the coronavirus's more severe impact on the elderly and the fact that older persons are isolating

themselves, even from their families, in the hopes of preserving their health. These scams have countless incarnations and will be vigorously prosecuted under elder law statutes as well as the highly flexible wire fraud and mail fraud criminal statutes.

In the midst of the high demand for healthcare and the possible overwhelming of our healthcare system in many parts of the country, regulators will be vigilant about investigating state and federal program fraud, including Medicare and Medicaid, false insurance claims and other false claims as people take advantage of the chaos. If the government itself takes on an increased role as a provider of health services or supplies, there will likely be an increase in significant False Claim Act lawsuits, with a corresponding uptick in intervention by the DOJ.

Moreover, if the President activates any authority under the Defense Production Act, that will create entirely new avenues for enforcement, as that statute criminalizes willful violations of the Act.²⁷ The government may seek to apply these provisions broadly to ensure that no one defrauds the government or the public in ways that hamper the purpose of the President's orders.

Finally, as employees—including officers, directors and other senior officials—begin to believe their enterprises are failing, some may transfer assets to themselves in the hopes of getting paid before the business goes bust. These transfers may be criminally prosecuted under statutes prohibiting embezzlement, bankruptcy fraud, wire fraud and mail fraud. This same conduct may also result in civil liability, regulatory enforcement, and additional penalties in a bankruptcy or liquidation context (for example, fraudulent conveyances, transfers and preferences).

Given all of this activity, caution is clearly warranted for everyone to remain vigilant for potential scams. To the extent the government manages to recover ill-gotten gains, however, the government often seeks to return those funds to victims as well as whistleblowers who assist the government in detecting and rooting out illegal behavior.

In the wake of the current crisis, a heavy wave of enforcement is likely on the way. Many will be subject to investigation for their conduct during the coronavirus crisis, both intentional and accidental wrongdoers. In this regard, history tells us that the SEC, DOJ and other agencies will seek to make examples out of those they perceive crossed a line, especially during a public health emergency and unprecedented global pandemic.

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NOTES

- ¹ SEC, “Enforcement Actions Addressing Misconduct that Led to or Arose From the Financial Crisis” (Oct. 7, 2016), available at sec.gov/spotlight/enfo-actions-fc.shtml.
- ² Att’y Gen. William Barr, Memo to all US Attorneys, “COVID-19—Department of Justice Priorities” (March 16, 2020), available at justice.gov/ag/page/file/1258676/download.
- ³ The SEC pursued 528 actions against 1,093 individuals and entities for insider trading during the period 2008-2018. During that same period, the US Attorney for the Southern District of New York alone secured the conviction, by trial or guilty plea, of 105 defendants in insider trading cases. Taleah E. Jennings, “Penalties, Short-Swing Profits, and Whistleblower Awards at 21-3,” in Harry S. Davis, ed., *Insider Trading Law and Compliance Answer Book* (Practising Law Institute 2020).
- ⁴ Stephanie Avakian & Steven Peikin, SEC, “Statement Regarding Market Integrity” (Mach 23, 2020), available at sec.gov/news/public-statement/statement-enforcement-co-directors-market-integrity. For more detail on this nuanced area of the law, see Harry S. Davis, ed., *Insider Trading Law and Compliance Answer Book* (Practising Law Institute 2020) (Answer Book).
- ⁵ Compare *United States v. Rajaratnam*, No. 11-4416-CR, 2013 U.S. App. LEXIS 12885, at *4-6 (2d Cir. June 24, 2013) (following Rule 10b5-1 to hold that “knowing possession” is sufficient but noting that the jury instructions at issue contained a component that required the “use” of the material nonpublic information), with *United States v. Jun Ying*, No. 1:18-cr-74-AT, 2018 WL 6322308, at *5 (noting the Eleventh Circuit does not follow Rule 10b5-1 in civil or criminal actions but instead requires “use” of the material nonpublic information).
- ⁶ For more information, see Gary Stein and Martin L. Perschetz, Chapter 5, “Scienter and Trading ‘On the Basis Of,’” in Answer Book, *supra* n.4.
- ⁷ For more information, see Howard Schiffman, Chapter 10, “Tipper and Tippee Liability,” in Answer Book, *supra* n.4; see also, “Second Circuit, in Split Decision, Overrules Limitation on Insider Trading Liability Established in *U.S. v. Newman*,” *SRZ Alert*.
- ⁸ “Enforcement Update: Insider Trading and COVID-19 Political Intelligence,” *SRZ Alert*.
- ⁹ *United States v. Blaszczyk*, 947 F.3d 19, 26-29 (2d Cir. 2019).
- ¹⁰ *Id.* at 35.
- ¹¹ “Insider Trading Law in Flux—What Advisers Need to Know,” *SRZ Alert*.
- ¹² Chairman Jay Clayton, SEC, “Proposed Amendments to Modernize and Enhance Financial Disclosures; Other Ongoing Disclosure Modernization Initiatives; Impact of the Coronavirus; Environmental and Climate-Related Disclosure” (Jan. 30, 2020), available at sec.gov/news/public-statement/clayton-mda-2020-01-30; see also SEC Office of Compliance Inspections and Examinations, “2020 Examination Priorities,” available at sec.gov/about/offices/ociel-national-examination-program-priorities-2020.pdf.
- ¹³ Press Release, SEC, “SEC Provides Conditional Regulatory Relief and Assistance for Companies Affected by the Coronavirus Disease 2019” (COVID-19) (March 4, 2020), available at <https://www.sec.gov/news/press-release/2020-53>; see also SEC Division of Corporate Finance, “Coronavirus (COVID-19) Disclosure Guidance” (March 25, 2020)

- (highlighting several areas to consider in formulating appropriate disclosure during the pandemic).
- ¹⁴ *Basic Inc. v. Levinson*, 485 U.S. 224, 231 (1988) (quoting *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 448-449 (1976)).
- ¹⁵ See *Matrixx Initiatives, Inc. v. Siracusano*, 563 U.S. 27, 38 (2011) (an omission becomes “material” if a reasonable investor would find the omitted fact would have altered the “total mix” of information available); *Gallagher v. Abbott Labs.*, 269 F.3d 806, 807-810 (7th Cir. 2001) (finding no duty to correct and requiring positive law to impose the duty to disclose).
- ¹⁶ For more information, see Douglas I. Koff, Chapter 11, “Regulation Fair Disclosure,” in *Answer Book*, *supra* n.4.
- ¹⁷ SEC, “Coronavirus (COVID-19) Response” (last updated March 24, 2020), available at <https://www.sec.gov/sec-coronavirus-covid-19-response>.
- ¹⁸ Press Release, DOJ, “Pennsylvania Attorney Indicted for Role in \$2.7 Million Ponzi Scheme” (March 24, 2020), available at <https://www.justice.gov/opa/pr/pennsylvania-attorney-indicted-role-27-million-ponzi-scheme>.
- ¹⁹ DOJ’s initial analysis of the pandemic goes so far as to consider charging persons who intentionally spread the virus with terrorism. Deputy Att’y Gen. Jeffrey Rosen, Memo, “Department of Justice Enforcement Actions Related to COVID-19” (March 24, 2020), available at <https://www.politico.com/ff?id=00000171-128a-d911-aff1-becb9b530000>.
- ²⁰ Makini Brice & Sarah N. Lynch, “U.S. launches probes as Trump bans hoarding, price gouging to combat coronavirus,” *Reuters* (March 23, 2020), available at <https://www.reuters.com/article/us-health-coronavirus-usa-order/u-s-launches-probes-as-trump-bans-hoarding-price-gouging-to-combat-coronavirus-idUSKBN21A3Q8>.
- ²¹ For example, Deputy Ass’t Att’y Gen. Richard A. Powers, “Remarks on the State of Criminal Antitrust Enforcement in 2020” (Miami, Fl. Feb. 7, 2020), available at <https://www.justice.gov/opa/speech/deputy-assistant-attorney-general-richard-powers-delivers-remarks-state-criminal> (highlighting several recent prosecutions directed at “combatting collusion in global financial markets”).
- ²² DOJ Antitrust Division, “FY 2021 Budget Request at a Glance,” available at <https://www.justice.gov/doj/page/file/1246781/download>.
- ²³ Press Release, DOJ, “Attorney General William P. Barr Urges American Public to Report COVID-19 Fraud (March 20, 2020), available at <https://www.justice.gov/opa/pr/attorney-general-william-p-barr-urges-american-public-report-covid-19-fraud>; DOJ Antitrust Division & FTC Bureau of Competition, Joint Antitrust Statement Regarding COVID-19” (March 2020), available at <https://www.justice.gov/atr/joint-antitrust-statement-regarding-covid-19>.
- ²⁴ Press Release, DOJ, “Justice Department Files Its First Enforcement Action Against COVID-19 Fraud” (March 22, 2020), available at <https://www.justice.gov/opa/pr/justice-department-files-its-first-enforcement-action-against-covid-19-fraud>.
- ²⁵ “Homeland Security Warns of Coronavirus-Related Cybersecurity Risks—Considerations for Private Fund Managers; Broker-Dealers: B-D Guidance on Increased Cybersecurity Risks Due to the COVID-19 Pandemic,” *SRZ Alerts*.
- ²⁶ For example, “Different Strokes: Interpreting Computer Fraud and Abuse Act,” *New York Law Journal*.
- ²⁷ 50 U.S.C. § 4513 (the willful performance of a prohibited act or failure to perform a required act is punishable by a fine of \$10,000, a year in prison, or both).

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