

Insider Trading and the COVID-19 Impact

Sam Gandhi, Nader Salehi, and Sara George

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Sam Gandhi:

Volatile stock markets are creating more opportunities for insider trading. As U.S. businesses try to return to normal in this time of COVID, the SEC is ramping up its response to potential securities violations, and regulatory attention isn't limited to the United States. The UK's Financial Conduct Authority is warning companies to further protect their inside information. So, how has enforcement of insider trading changed and how can companies mitigate their risk? We'll find out in today's podcast.

Male Speaker:

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Female Speaker:

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Male Speaker:

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Sam Gandhi:

From the international law firm Sidley Austin this is the Sidley Podcast where we tackle cutting edge issues in the law and put them in perspective for business people today. I'm Sam Gandhi. Hello and welcome to this special edition of the Sidley Podcast, episode number 12. Today, we're focusing on insider trading and how its enforcement has changed over time, particularly in this era of volatile markets precipitated by the COVID-19 pandemic.

I'm joined by Sidley partners Nader Salehi and Sara George. Nader is the co-head of Sidley's global Securities Enforcement and Regulatory practice

and represents investment banks, investment advisors, public companies, and senior corporate officers in high-profile and complex securities matters. He works with virtually every major bank on Wall Street and has had a role in almost every major Wall Street sweep in recent years. He's a partner in the firm's Washington, D.C., office.

And Sara's a partner in Sidley's London office and has a wealth of experience in UK and international regulatory and criminal investigations. She is a former prosecutor of insider dealing for the UK Financial Services Authority and she represents clients against allegations of involvement in regulatory contraventions and criminal offenses. And she is a partner in the firm's White Collar: Government Litigation and Investigations and Securities Enforcement and Regulatory practices. Nader joins us from Washington, D.C., and Sara joins us from London today. Nader and Sara great to see you today.

Nader Salehi:

Thanks for having us Sam.

Sara George:

It's great to be here. Thank you.

Sam Gandhi:

Insider trading has been a significant concern in the COVID-19 era. Given this new landscape, it's worth noting that the definition of insider trading and the way it's being enforced by regulatory authorities has changed over time. So, Nader, how relevant is the issue of insider trading today?

Nader Salehi:

Thanks, Sam, for hosting this podcast. You know insider trading I think in some ways is the only issue if you look at the docket of the SEC that stays relevant. It stays relevant regardless of whether you have a Democratic administration or a Republican administration. It stays relevant whether there are other issues that come to and from the floor. And it stays relevant, I think, because it really strikes at a basic concept of equity that everyone understands when it comes to the operations of the markets. And so, if you look at the cases that the SEC brings it's the one issue that stays roughly consistent in terms of the percentage of actions that the SEC brings.

So, it's relevant to them year in, year out. And I think in light of what's happening with the volatility of the markets, I think in March we had one of the most volatile markets we've ever had, people understand that the opportunities for abuses are even more prevalent than they would be otherwise. And I think people are attuned to the need to ensure equity and level playing fields in the markets when you have that type of volatility. Yes, you're absolutely right, Sam, that over the last, you know, decade or so, we've had a lot of debate about what exactly insider trading means.

We've had a lot of cases come out at the appellate level and the Supreme Court level about the nuances of the definition and what constitutes a duty and a breach. But in a lot of ways I think those cases go to definitional points that really matter more to lawyers arguing appeals of insider trading actions than they do to the basic definition of what it is and how it's enforced and how relevant it is. I think those issues have stayed constant, notwithstanding the litigation and the debate that takes place around the margins, exactly how the law gets applied to very specific fact patterns.

Sam Gandhi:

So, let me just follow up on that. Some commentators have said that it's easier for the Justice Department to bring an insider trading case now. It's harder for the Justice Department to bring an insider trading case now. Given your statement that it really hasn't changed very much, do you think that any of those statements are true?

Nader Salehi:

Well, when you speak about the Department of Justice it is true that depending on who's the attorney general and who's in power at the administration that insider trading can be more or less relevant to the people that are choosing the cases to bring. And really when I'm focused on insider trading, I was talking more about the SEC, which is the primary, albeit civil, enforcer of the insider trading actions in the U.S. And I think with the SEC it's something that they very much view as their bread and butter and their raison d'être.

But I think with the Department of Justice we have had ebbs and flows where, notwithstanding what the SEC does, the Department of Justice sometimes, depending on who's in power, decides that it's worthwhile to add criminal enforcement to insider trading. And so, yes, you see ups and

downs not in how easy it is or how hard it is because they know how to do it, they have the technology to do it, and have a legal framework to do it. But the Department of Justice sometimes decide it's worth their resources to pursue those cases and sometimes it doesn't depending on who's the attorney general and who are the U.S. attorneys in the various jurisdictions. For example, Preet Bharara very famously decided it was in the interest of the U.S. Attorney's Office for the Southern District of New York to dedicate resources to criminally bring significant insider trading actions and he did so very famously and very successfully.

And so, that's an example of a puritan time when it was very active. It was very active in the '80s during the Michael Milken and Boesky years. In between, you had probably a bit of an ebb in terms of how much criminal authorities focused on insider trading. But while the Department of Justice kind of comes in and out of the picture, depending on what their priorities are, when you look at the SEC, which is the primary regulator when it comes to insider trading, albeit they're civil and the Department of Justice as you know is criminal, the SEC sort of has been very consistent in terms of how focused they are on insider trading.

Sam Gandhi:

So, let me pick that up with Sara, because on the other side of the ocean the UK Financial Conduct Authority is not, you know, they are the authority there's no real dichotomy in terms of jurisdiction. And they recently published expectations for market conduct just in the context of increased capital raising events and also alternative working arrangements, because most people are working from home due to the pandemic. Sara, what has the FCA said regarding their expectations for market conduct?

Sara George:

Well, the FCA is acknowledging that conventional surveillance is less successful in an environment of continued market moving news. It's important to us they're a conduct regulator and they are acknowledging that there is an inability to police information barriers, but also that the current environment is creating that conduct risk. With financial pressures, psychological stress, and a significantly lower risk of being apprehended, there's a creation of the prospect of an opportunistic criminal. And the FCA very much regards this as primarily a criminal matter.

There are powers to pursue insider dealing through the civil route, but ultimately the FCA regards this as cheating in that it fundamentally undermines confidence and the integrity of the UK markets and it fundamentally undermines the confidence of investors. And when we are opening these cases, as I did once to jurors, we always describe it as cheating, as effectively stacking the cards in your favor. So, that's very much the approach that the FCA takes to it. It's not so much interested in technical defenses or which regulatory route it is it sees it as criminal, it sees it as essentially undermining confidence in the UK, which is really important right now with BREXIT, and it will always pursue things criminally if it can.

Sam Gandhi:

So, what have they actually done with employers? Have they made employers change how they are conducting their business? Have they looked at how employers are having their employees conduct their business remotely in the wake of this pandemic?

Sara George:

They have published guidance, but they are very conscious that in an environment that's moving all the time and the environment in which young professionals tend to be working in cities like London where they tend to share houses and people often come to London from outside, you will have people from multiple and different institutions, even the public service, sharing IT facilities, printing, and accommodations. They will not have the same information barriers and the opportunity to police them in the way that they used to. So, there's much a focus upon ethics and the importance of staying in touch with your employees, particularly the very young. And making sure that those ethical cues are there and making sure that people understand what's expected of them, but also the consequences if they fall short.

Sam Gandhi:

Nader, let me go back to you in terms of enforcing insider trading in the United States. You know we're all in this era of COVID all over the place, very few people are actually at their desk, et cetera, where they've got the protection of firewalls and things like that. So, beyond its facilitation of potential violations, how has technology impacted how insider trading is being enforced?

Nader Salehi:

That's a very good question, Sam. Technology has played a really important role in the way, I think, insider trading is conducted by those who perpetrate it and also how insider trading is enforced by the authorities who seek to identify and sanction it. It's a bit of a cat and mouse game that is very interesting to watch with respect to the proliferation of technology. What you see, you know, if you think about how insider trading occurs, you have conversations and communications that take place between somebody who has material on nonpublic information and somebody who's going to trade based on it. And so, how that communication takes place has changed with technology.

Obviously, you can continue to talk to people face-to-face, but you now have all sorts of apps that allow people to have communications in a way that is encrypted and less difficult for a regulator to obtain. Now, the regulators understand that. And so, what you see is a cat and mouse game where communications, improper communications take place through technologies that are new and more and more difficult to track and to subpoena. And you have the regulators figuring that out, playing catch up and in their subpoenas and in their enforcement actions seeking the production of personal communications, encrypted communications, images of devices, things that you know really wouldn't have occurred to a regulator to ask for 20 years ago or 10 years ago.

You now regularly see the SEC come in and ask for chats and WhatsApp communications and images of devices. Those are not things they would've thought to do but I think as they see communication mechanisms develop, people get more and more creative about how they communicate about subjects that they shouldn't be communicating about, regulators figure that out. And so, that's a really interesting cat and mouse game to watch. The other thing that you see is technology being used by the regulators. The SEC has made a substantial investment in the technology that they use to detect improper trading.

And so, one of the ways the SEC often gets attuned to insider trading is by identifying what they perceive to be unusual trading patterns. And so, they've been able to leverage technology over the last decade or so in a way that they've never done before. Where they can look at market activity, public market activity, stock market activity, identify patterns of trading,

volatility in stocks that are the type of indicia that you would look for when there is insider trading. And so, the SEC and the regulators are increasingly leveraging technology to identify potential areas that they should be looking at for insider trading.

Sam Gandhi:

So, Sara, is the FCA also managing employers in terms of regulating social media conduct of its employees? And how are they surveilling alleged wrongdoing?

Sara George:

Well, they have two particularly powerful surveillance mechanisms. One is the potentially enormous trading ratio surveillance system, which looks for market participants who don't typically trade an investment or where a participant traded significantly more in the direction of an announcement, or where a participant made a significant profit from trading positions established in the period immediately prior to an announcement. So, that gives it quite a lot of data to start from.

But also what it's become quite adept at using is using mobile phone information on location finding. So, for example, identifying when two individuals happen to be collocated from the signals given off by their mobile phones because most people carry a mobile phone with them absolutely everywhere. So, that has been incredibly successful. One of their most successful prosecutions was the prosecution of a compliance officer and they identified that she was always within a very close collocation, her mobile phone was, to a trader at the time he was placing those trades.

And they went back to look at what she had been searching on her firm computer and they found that she had been looking up a lot of deal information in which she was not involved and had absolutely no reason to be accessing. So, this sort of information from mobile phones is incredibly useful. And this was a tactic borrowed, actually, from drugs and narcotics offenses, the use of location tracking data on mobile phones, which most people in insider dealing cases didn't think was a remote possibility.

Sam Gandhi:

I'm going to start leaving my phone at home now. All right, you're listening to the Sidley Podcast. We're speaking with Sidley partners Nader Salehi and Sara George about the impact of COVID-19 on insider trading and developments in market conduct. Nader co-heads Sidley's global Securities Enforcement and Regulatory practice and has had a role in almost every major Wall Street sweep in recent years. And Sara represents clients against allegations of involvement in regulatory contraventions and criminal offenses. And as the business world continues to expand in global markets, and as the trading of shares, bonds, derivatives, and other instruments continue to increase, the pandemic has inspired greater scrutiny and pose particular risks to traders. Nader, have you seen something that's different or interesting about the way that the SEC has approached insider trading in this pandemic era?

Nader Salehi:

I think I would point to two things, Sam. First, I think that the SEC has taken greater liberties and exercised greater flexibility in how they apply the definition of insider trading to market moving information. And so, what I think that we've seen in the pandemic, as an example, is they understand that there's a lot of volatility. They understand that, in particular, given what's happening, there's a volatility in the shares of drug companies that are involved in the development of potential vaccines. And they understand that there are things that are being communicated to the public, for example drug trial information, that are significantly market moving with respect to those stocks.

And so the SEC has been very active in their pronouncements and their cases, taking what is the sort of normal longstanding definition of insider trading but applying it aggressively to context, like the one I just described. Stretching a little bit sometimes what is material information, stretching a little bit sometimes what are the duties that people owe to companies that they work for or do drugs test for, and try to find ways to stretch that definition to apply to these particularly relevant contexts in a way that perhaps they wouldn't have stretched, you know, several years ago. So, I think that's one.

I think the other thing that I would say, and it's hard to know whether this is related to the pandemic or just coincident with the pandemic, I think the

SEC, particularly in the investment management space, is saying we expect managers, whether it's hedge fund or private equity managers, to really ramp up and step up their game in terms of their own policies and procedures and compliance frameworks for the detection and prevention of insider trading. And so, what we've seen is a number of cases where the SEC has gone after firms who didn't actually engage in insider trading or who at least weren't charged with insider trading. But they were nevertheless penalized substantially by the SEC for not having what the SEC perceived to be a robust compliance framework to detect insider trading.

And so, what's happening is that they want to see investment managers develop the same types of robust controls and frameworks around the prevention of insider trading that they're used to seeing on the sell side of the street. They know that investment banks have for years invested resources and developed frameworks like that. I think what we're now seeing is the SEC turning to the buy side of the street and say we want you guys to try to work towards developing the same types of control frameworks to prevent insider trading.

Sam Gandhi:

Sara, in the UK what are the big differences in how insider trading laws are enforced versus in the U.S.?

Sara George:

Well, the U.S. government has historically been a more aggressive enforcer and it has sought the extradition of UK-based suspects where it believes its markets have been abused. However, what we have seen here is the introduction of a forum bar for extradition offenses. That's effectively a barrier to extradition where the UK is a more appropriate venue for a trial. And I think the result is that, that will increase pressure on UK prosecutors to go to trial in the UK rather than extraditing suspects to the U.S. Although there is a civil enforcement regime for misuse of insider information, it's almost always that insider dealing is prosecuted criminally because of its impact on public confidence and the integrity of the UK markets. So, I think the UK is looking enviously at the U.S. and its significantly higher success rate and is keen to learn why it is, and to look and to borrow some of those technologies and some of those approaches.

Sam Gandhi:

So, do you see, Sara, in the future there is going to be, as you see more volatility in global markets and global markets kind of coalesce more, that there will be more cooperation, more joint investigations between the SEC and the FCA?

Sara George:

Well, the cooperation is already pretty strong. There are very close relationships between both regulators. They are working to a common purpose, the relationships are strong, and frequently you see the FCA stepping down or stepping away from a case where it is likely to be detrimental to the U.S. enforcement action, so it's not uncommon to see that. There are also secondees from both organizations working together. So, I think what we will see is continued strong cooperation, strong relationships in the interest of market integrity.

Sam Gandhi:

Nader, can I follow up on that with you? Because you just heard Sara talk about the FCA potentially stepping out of the way where they see an interest of the U.S. authorities in prosecuting insider trading cases. How do you confront issues with that cross-border application of insider trading laws?

Nader Salehi:

You know what we see given the proliferation of financial products and the development of globalized financial markets is we increasingly see market participants who have a particular theory or a thesis on a company seeking to affect that thesis by trading in more than one market. You know simultaneously have people sitting in New York trading in New York, London, Singapore. or some other combination of jurisdictions. And so, the question that comes up is are you bound by the laws of the jurisdiction that you're operating in? Are you bound by the insider trading laws of the jurisdiction where you're effectuating the trade or are you bound by the laws of the jurisdiction in which the trade is actually being executed on a market?

And so, the answer when that question comes up that we offer is yes, as unhelpful as that is. The answer is that you are bound, typically, by the laws of not only the U.S. if that's where the trade is emanating, but also by the

laws of whatever market it is that the trade is being executed in. And so, let's take an example of a UK, U.S. trade. In the UK, as you probably well know, when you look at the definition of insider trading they don't have a duty element. Their view is that you can't be trading while in possession of nonpublic information. I know enough to be dangerous on that subject. But in the U.S. that's a key element of the definition. And so, what we often do is we have to talk about market participants and make them understand the definition is conceptually the same, but not exactly the same when you get into the details.

You need to understand what the insider trading laws require of you both where the trade is emanating and where it's being executed. And what most careful global market participants do is play to the lowest common denominator. If you're going to have applied against your trade the laws of two or three different jurisdictions make sure that the trade is compliant with whatever is the most restrictive regime applicable to that trade. And that often is difficult for people to get their heads around, but that is what careful market participants do.

Sam Gandhi:

Sara, I'm going to ask you both for predictions, but let me start with you. What do you see as the emerging trends for insider trading?

Sara George:

I think the FCA is going to feel compelled to respond to public anger at those who cheat in the financial markets at the time of national crisis. So, that's my first prediction. And I think firms will respond by treating market misconduct by their employees with the utmost seriousness. And they'll be more inclined to dismiss employees suspected of breaching conduct laws, even where those may not amount to insider dealing. So, I think, market participants will start finding they are policed with increased stringency by their own institutions. I think there's also likely to be an increased focus on those who are in positions of trust who abuse that trust. For example, we're seeing focus on compliance risk legal functions and those individuals who are expected to set and police the standards of market conduct within the firm. So, I think, focusing upon the policers within organizations to do their job will be key.

Sam Gandhi:

And for both of you, as we wrap up, what's the one piece of advice that you have for the general counsel of a trading organization or an investment bank as they start figuring out how to manage this potentially new landscape with this almost historical volatility? As well as, as Sara pointedly said, this national and international crisis that's out there and potential increased regulatory scrutiny?

Nader Salehi:

Well, Sam, let me first give you my prediction. My prediction in terms of what to look for in the U.S. when it comes to insider trading. I think years from now we will look back and we will say that the insider trading issue that really bubbled up was insider trading conducted on the basis of nonpublic market moving information emanating from government agencies and those individuals associated with and working with government agencies. I think people who are working in the financial markets have learned over time what they can and can't do, but I think people forget the same basic concepts apply to market moving information emanating from government agencies and people working with government agencies.

And I think, particularly in light of the pandemic and the things that are happening in terms of government's impact on the market, I think we're going to see cases come out where people who are working either for or with agencies taking advantage of the privileged access they have to information, trading on it, sharing it with others who are trading on it, and eventually being prosecuted for it by the SEC and/or the Department of Justice. So, that's my prediction. In terms of what I would tell a GC, if I had to say one thing and I think it's something that we often say, but is particularly relevant in the current environment of substantial volatility it's the following: Any nonpublic information that you have, assume its material.

Clearly, part of the definition of insider trading involves an analysis of whether or not the information you have is material, so I'm not saying that's off the table as a legal matter. But what I would say is, you know, materiality is a mixed question of law and fact and that means that you can look at something and say here are all the reasons why I don't think this is material. And the SEC can look at it and say fair enough, we think it is material to mixed question of law and fact, let's put it to a jury and see. And so, I think that a careful GC and a prudent GC should assume every piece

of nonpublic information they have is going to be judged to be material. And they should only feel comfortable moving forward with a trade once they're comfortable that the nonpublic information that they have is not going to be judged to have breached the duty of confidence or trust when they trade. So, that's the one piece of advice I think I would leave people with.

Sara George:

I think I would say to GCs, particularly those working in corporate's outside the financial services sector, is keep a really tight hold on your nonpublic information and think about its market moving impact. Because I think it's the creation of the window of opportunity for these insider trades to occur that is going to become fundamentally problematic. And I think increasingly we will see regulators going to institutions and saying why did you not make those announcements sooner? You may not have been able to quantify precisely the market impact of that news, but you knew it was important, you knew it was going to have an impact. And I think we will start seeing more focus on that type of information and the assessment criteria around it.

Sam Gandhi:

We've been speaking with Sidley partners Nader Salehi and Sara George on the changing perception of insider trading over the years and the recent impact of COVID-19. And what businesses should do to protect themselves in this new era of insider trading. Nader and Sara thanks for sharing your insights today.

Sara George:

Thank you.

Nader Salehi:

Thanks for having us, Sam. It was fun.

Sam Gandhi:

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