Securities Regulation Daily Wrap Up, TOP STORY—Spring loading and bullet dodging: House Financial Services probes pandemic-related stock tricks, (Sept. 18, 2020)

Securities Regulation Daily Wrap Up

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Concern has grown about whether pharmaceutical companies executives are profiting unfairly from stock maneuvers in connection with taxpayer-funded COVID-19 interventions.

As questions swirl about whether pharmaceutical insiders might be improperly cashing in on inside information about COVID-19 vaccine development, a House Financial Services subcommittee held a hearing to examine whether changes might benefit the current insider trading regime. Among other questions, witnesses discussed whether executive compensation based on stock options might be legal yet problematic, and whether the SEC is doing all it can to combat insider trading in the context of the COVID-19 pandemic.

The hearing, "Insider Trading and Stock Option Grants: An Examination of Corporate Integrity in the Covid-19 Pandemic," was held by the Subcommittee on Investor Protection, Entrepreneurship, and Capital Markets on September 17, 2020. A committee memo accompanied the hearing.

Stock options and trading by pharmaceutical executives. According to Subcommittee Chairman Brad Sherman (D-Calif), the hearing was prompted by concerns that pharmaceutical company insiders may be profiting unfairly from knowledge about COVID-19 vaccine development. In one example related by Rick Claypool, a research director at Public Citizen, Sen. Elizabeth Warren (D-Mass) asked the SEC to investigate the grant of 1.75 million stock options to Kodak executives one day before the company announced it would receive a $765 million federal contract to produce pharmaceutical ingredients. Within two days after the announcement, Kodak's shares soared more than 1,000 percent and the value of the stock options rose to $50 million.

In another example, executives at Moderna Therapeutics, a frontrunner in the vaccine race, sold about $90 million in shares in the days following the announcement of a successful clinical development that pushed up the stock price about 30 percent. Public Citizen is especially concerned with profiteering in instances, as with Moderna, where COVID-19 interventions are 100 percent taxpayer-funded.

Stock options tricks: "legal but wrongful." Many participants discussed whether current law and regulation adequately address "legal but wrongful" activity around stock options grants. Sherman said that when shareholders approve a plan that says that stock options will be granted with a stock option exercise price equal to "fair market value" on an option grant date, they believe that executives who get these stock options will live by that. The problem is that "fair market value" does not reflect material inside information that is going to be announced the next day or the next week, said Sherman.

"I want to say thank the insiders at Kodak who have added insult to injury," said Sherman. "First, they granted stock options at what they knew to be an unfairly low price. Then they spent a lot of shareholder money on a corporate law firm to tell them it was all legal. That memo tells us we've got to change the law. Because if any major firm can say this is legal, it shouldn't be."

Spring loading and bullet dodging. Jacob Frenkel, chair of Government Investigations and Securities Enforcement at Dickinson Wright, discussed gray-area practices called "spring loading" and "bullet dodging." He defined spring loading as holding back the release of positive information until after the option grant date, while bullet dodging refers to temporarily depressing the stock price by releasing negative information before a stock option grant date.

Rep. Jim Himes (D-Conn) asked if insider trading law can be broadened to include "conveyance of value," or if an entirely separate statute is needed to capture value that is conveyed via stock option grants rather than the purchase or sale of securities. Frenkel responded that information insiders are always going to have access to information that is imbalanced perspective that the rest of the market. While the issue of information imbalance favoring corporate executives is a relevant issue, it really does not relate to insider trading, since it does not involve trading, and instead goes to disclosure issues, said Frenkel.

Insider trading enforcement. Turning from gray areas to bright lines, regarding whether enforcement is adequate against clearly illegal insider trading, several representatives said the SEC is doing its job. Subcommittee Ranking Member Bill Huizenga (R-Mich) stated that 2019 was a record year for SEC enforcement, citing that last year SEC brought 862 enforcement actions, obtained over $4.3 billion in disgorgement and civil penalties as well as nearly 600 bars against market participants, suspended trading of 271 companies' securities, and returned nearly $1.2 billion to harmed investors.

In Huizenga's view, it is not the committee's job to "name and shame" perceived wrongdoers, and instead the committee should focus on getting the economy back on track with legislation addressing crowdfunding and small business mergers, among other measures. This theme was echoed by Full Committee Ranking Member Patrick McHenry (R-NC), who took the occasion to introduce the "Gig Worker Equity Compensation Act," which would extend eligibility for equity compensation to non-traditional workers.

According to Frenkel, the SEC has been "very aggressive" and "very vigilant" in enforcing against COVID-19-related misconduct. While the numbers may be down, there have been 40 trading suspensions specifically related to issuers in the COVID-19 solutions space. Frenkel observed that the SEC has been dealing with staff reductions, and thinks the division is still very active and that we are seeing the results of reprioritization over the last 18 months.

But others expressed doubt that the SEC is doing everything it should. Claypool said that Public Citizen has found that insider trading enforcement specifically has plummeted during the Trump Administration. As reported by NPR, while other enforcement areas have grown, insider trading cases made up less than 4 percent of SEC enforcement actions last year, a decades-long low. According to data, the SEC brought just 32 insider trading enforcement actions in 2019, the lowest number since 1996, and charged 46 defendants, the lowest number of defendants in insider trading cases since Ronald Reagan was president, and about half of the annual average over the last three decades.

"I do not have great confidence in the SEC at the moment," said Rep. Juan Vargas (D-Calif). "Their enforcement's way down."

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