SEC Enforcement and COVID-19: Disclosure and Insider Trading Risks for Issuers

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In response to the widespread outbreak of the COVID-19 pandemic in the United States, the U.S. Securities and Exchange Commission (SEC) has granted some flexibility to issuers with respect to their obligations to file periodic reports and deliver proxy and information statements to shareholders under the Securities Exchange Act. On March 4, the SEC issued an exemptive order granting affected public companies, subject to certain conditions, an additional 45 days to file or deliver those materials. The SEC's order is available here. (On March 13, the SEC also granted similar relief to investment advisers, which we discussed here.)

Issuers should not, however, anticipate similar leniency from the SEC with respect to the accuracy of their disclosures. To the contrary, the press release accompanying the exemptive order (available here) makes clear that the agency will expect fulsome and accurate disclosure from companies concerning the impact of the COVID-19 crisis on their operations and financial condition, as well as their responses to it. In Chairman Jay Clayton's words, companies must "provide investors with insight regarding their assessment of, and plans for addressing, material risks to their business and operations resulting from the coronavirus to the fullest extent practicable to keep investors and markets informed of material developments," especially because these details "can be material to an investment decision[.]" (This echoes a similar admonition from the Chairman on January 30.)

Moreover, the release cautions issuers "to take the necessary steps to avoid selective disclosures and to disseminate such information broadly" and to "consider whether it may need to revisit, refresh, or update previous disclosure to the extent that the information becomes materially inaccurate" – a plausible, if not likely, scenario for many companies given the fluidity and as yet unknown extent of the pandemic. The SEC's statement goes on to note that companies can avail themselves of the safe harbor in Section 21E of the Exchange Act in addressing "known trends or uncertainties" regarding COVID-19.

In addition, the release signals that the SEC will scrutinize issuers' internal controls governing the accuracy of their public filings during and concerning the crisis. In particular, it urges companies "to work with their audit committees and auditors to ensure that their financial reporting, auditing and review processes are as robust as practicable in light of the circumstances in meeting the applicable requirements."

Public companies are especially well-advised to be attentive to this guidance because the SEC's Division of Enforcement remains closely focused on securities offering and issuer reporting and accounting matters, which constituted 21 and 17 percent, respectively, of the stand-alone cases that the SEC filed in fiscal year 2019 – the second and third largest categories of enforcement actions. The March 4 release makes plain that, in the context of the COVID-19 pandemic, these will remain Enforcement priorities for the foreseeable future.

Issuers should also be mindful that the SEC is not the only audience they need to be concerned about. Class action lawyers, in the wake of the economic downturn that will follow the pandemic, will no doubt exhaustively review issuers' COVID-19-related disclosures to find a basis for filing suit upon the stock price drops that often follow such disclosures. Indeed, plaintiffs' lawyers filed putative securities class actions based on disclosures relating to previous public health crises, including outbreaks of SARS, norovirus and "mad cow" disease. Not surprisingly, two COVID-19-related securities class actions have already been filed against issuers: one against Norwegian Cruise Lines Holdings, Ltd. in the U.S. District Court for the Southern District of Florida for allegedly downplaying the impact of COVID-19 on its business; and another against Inovio Pharmaceuticals, Inc. in the Eastern District of Pennsylvania based on allegedly false statements about its development of a COVID-19 vaccine. Officers and directors also face the risk of shareholder derivative litigation that may be filed along with class actions. To minimize their exposure to private litigation and narrow the scope for allegations that disclosures were false, inadequate or mismanaged, issuers should aim for specificity rather than broad, general statements about the impacts of COVID-19.

Issuers should note in this regard that the threshold for liability under the federal securities laws varies depending upon the nature of the

transaction. Although liability under Exchange Act Rule 10b-5 requires a showing of scienter – *i.e.*, intent to defraud – material misstatements and omissions in securities offerings can give rise to liability against an issuer, officer or director under Sections 12(a)(2), 17(a)(2) and 17(a)(3) of the Securities Act for mere negligence, while issuers face strict liability under Section 11 of the Act for a misstatement or omission in a registration statement or prospectus, without regard to their state of mind. Attention to these issues is especially critical given that the economic fallout from the pandemic, already starkly in evidence, may heighten temptations to flatter financial performance, downplay risks and negative eventualities and marginalize or overlook internal controls, policies and procedures. This same pressure also engenders an increased risk of insider trading, as those privy to material non-public information about the negative impacts of COVID-19 on financial performance may be motivated to sell shares before that information is publicly disclosed or tip others with that information.

The SEC release could hardly be more explicit on this point, stating bluntly that "where a company has become aware of a risk related to the coronavirus that would be material to its investors, it should refrain from engaging in securities transactions with the public and to take steps to prevent directors and officers (and other corporate insiders who are aware of these matters) from initiating such transactions until investors have been appropriately informed about the risk." Here, as well, robust compliance, including training on the permissible handling of pandemic-related information and monitoring of employee communications, will be essential.

We will continue to provide updates on the SEC's approach to this quickly-developing crisis.

Foley Hoag has formed a firm-wide, multi-disciplinary task force dedicated to client matters related to the novel coronavirus (COVID-19). For more guidance on your COVID-19 issues, visit our Resource Page or contact your Foley Hoag attorney.

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