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SEC enforcement and litigation risks amid the COVID-19 pandemic

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In recent weeks, the Co-Directors of the SEC's Enforcement Division warned of the "importance of maintaining market integrity" in these uncertain times. Specifically, they urged public companies to be mindful of Regulation FD and insider trading laws, as rapidly changing market conditions could heighten the risks of violating such laws.[1] Also, on 8 April 2020, the SEC Chairman and Director of Corporation Finance encouraged companies to make robust forward-looking disclosures, in part, to provide the investing public access to high-quality financial information, even if some projections might have to be "update[d] and supplement[ed]" at a later date.[2]

This information from the SEC should alert companies to particular enforcement and litigation risks during the ongoing COVID-19 pandemic, which we discuss further below: (1) Regulation FD enforcement; (2) insider trading; (3) potential duty to correct or update theories of securities fraud liability; (4) risks of misleading statements outside of public filings; and (5) securities fraud class action lawsuits.

1. Regulation FD enforcement

The SEC has reminded companies disclosing material information related to the effects of COVID-19 to comply with Regulation FD (Reg FD),[3] which prohibits selective disclosure of material nonpublic information to certain individuals (e.g., analysts or investors) without making the disclosure public to the broader market.[4]

At this time, companies may feel an urgency to update investors and market analysts through rapidly changing business conditions and plans, but they should ensure that material disclosures are broadly disseminated to the public and not to particular individuals. Companies and their executives should exercise caution and adhere to established corporate policies related to communications with third parties that are not open to the investing public, including one-on-

[1] Public Statement from Stephanie Avakian & Steven Pelkin, Co-Directors, SEC Div. of Enforcement, "Statement from Co-Directors of the SEC's Division of Enforcement, Regarding Market Integrity," (23 Mar. 2020), available here [hereinafter "SEC 23 March 2020 Statement"].

[2] Public Statement from Jay Clayton, Chairman, SEC, &William Hinman, Director, SEC Div. of Corp. Fin., "The Importance of Disclosure - For Investors, Markets and Our Fight Against COVID-19," (8 Apr. 2020), available here [hereinafter "SEC 8 April 2020 Statement"].

[3] Div. of Corp. Fin., SEC, "Coronavirus (COVID-19): CF Disclosure Guidance: Topic No. 9," (25 Mar. 2020), available here [hereinafter "SEC 25 March 2020 Statement"]; SEC 23 March 2020 Statement.

[4] 17 C.F.R. § 243.100.

one calls. In this current environment, investors and analysts want to know the impact of the pandemic on the company's financial condition and business operations, and there is a high likelihood that material information could be shared during any one-on-one calls with investors or analysts. Companies need to assess the risk of a possible Reg FD violation before they agree to let any company representative speak in any setting in which the investing public is not simultaneously provided with the same material information.

2. Insider trading

On 23 March 2020, the SEC specifically warned about the heightened potential for insider trading during this "unprecedented" period in the securities markets where insiders are "regularly learning new material nonpublic information that may hold an even greater value than under normal circumstances."[5] Given current conditions and market volatility, any person with material nonpublic information should exercise great caution before executing trades and should be careful to follow corporate controls and procedures for trading.

This risk is heightened, particularly given this month's news of the U.S. Court of Appeals for the Second Circuit's decision to deny a petition for rehearing in *United States v. Blaszczak* – a case that potentially makes it easier for prosecutors to bring criminal insider trading cases against insider tippers who did not obtain a "personal benefit."[6] In *Blaszczak*, the Second Circuit held that the "personal benefit" requirement did not apply to the wire fraud and Title 18 securities fraud (18 U.S.C. § 1348) statutes, although it is required for Title 15 securities fraud claims.[7] Although the practical effects of *Blaszczak* are yet to be determined, the holding itself means that even if an insider does not perceive or actually obtain any personal benefit regarding an improper disclosure of material nonpublic information to a tippee, he or she could still be prosecuted for insider trading.

3. Correcting or updating forward-looking statements

In the light of uncertainties created by COVID-19, the SEC recommended on 8 April 2020, that companies try to make "robust, forward-looking disclosures" that will benefit investors and, more broadly, promote the wider exchange of companies' plans to respond to the pandemic.[8] To mitigate the legal risks of such disclosures, the SEC encourages companies to avail themselves of traditional safe harbor laws, which generally protect companies from liability if the forward-looking statements are accompanied by meaningful cautionary language or if the person making the statement did not know it was false or misleading.[9]

The SEC, however, also recommends that companies "update and supplement" such forward-looking statements to the extent practicable.[10] Similarly, on 25 March 2020, the SEC advised companies to consider whether they "may need to revisit, refresh, or update previous disclosure to the extent that the information becomes materially inaccurate."[11]

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[5] SEC 23 March 2020 Statement.

[6] *United States v. Blaszczak*, 947 F.3d 19 (2d Cir. 2019). Under *Dirks v. SEC*, 463 U.S. 646 (1983), an insider tipper cannot be convicted of Title 15 securities fraud "unless the government proves that he breached a duty of trust and confidence by disclosing material, nonpublic information in exchange for a 'personal benefit.'" *Id.* at 35, citing *Dirks*, 463 U.S. at 663.

[7] *Id.* at 35.

[8] SEC 8 April 2020 Statement.

[9] *Id. See* 15 U.S.C. § 77z–2; 15 U.S.C. § 78u–5; *see also In re Cutera Sec. Litig.*, 610 F.3d 1103, 1112 (9th Cir. 2010); *Slayton v. Am. Express Co.*, 604 F.3d 758 (2d. Cir. 2010); *Carvelli v. Ocwen Fin. Corp.*, 34 F.3d 1207 (11th Cir. 2019); *Dougherty v. Esperion Therapeutics, Inc.*, 905 F.3d 971 (6th Cir. 2018).

[10] SEC 8 April 2020 Statement.

[11] SEC 25 March 2020 Statement.

These statements are notable because the federal securities laws generally do not impose an affirmative duty to disclose all material developments as they occur.[12] The contours of a "duty to update" theory of liability vary across courts. The Seventh Circuit has rejected the theory, holding that a company "has no duty to update forward-looking statements merely because changing circumstances have proven them wrong."[13] Nevertheless, other courts refer to a "duty to update" theory of liability that may exist when a statement is true when made, but becomes misleading because of a subsequent event and is therefore in need of "updating."[14] According to some courts in the Second Circuit, for example, such an obligation does not extend to vague statements of optimism, immaterial statements, or statements that do not remain "alive" in the minds of investors such that they are perceived to be continuing representations.[15] In other words, the more material and definitive the forward-looking statement, the more likely it may need to be updated at a later date, if such a theory of liability is even viable.

Some courts have found a "duty to correct" prior statements when a company learns that a prior disclosure was untrue when made.[16] According to some courts, this possible duty is less likely to apply if the original statement was vague[17] or if the new purportedly "correct" information is unreliable, containing only "tentative internal estimates."[18] Also, if a previous statement is suspected to be false, the company may be "entitled to investigate for a reasonable time" to ascertain whether a correction is necessary.[19]

Thus, although companies should strive to answer the call of the SEC to provide forward-looking disclosures in the midst of the COVID-19 pandemic, they should be wary of potential arguments that such disclosures were not adequately corrected or updated. The SEC attempts to assuage

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[12] For example, Judge Frank Easterbrook put it succinctly: "The securities laws create a system of periodic rather than continual disclosures." *Higginbotham v. Baxter Int'l, Inc.*, 495 F.3d 753, 760 (7th Cir. 2007).

[13] *Stransky v. Cummins Engine Co., Inc.*, 51 F.3d 1329, 1333, n. 9 (7th Cir. 1995); *see also Gallagher v. Abbott Labs*, 269 F.3d 806, 810 (7th Cir. 2001) ("In order to maintain the difference between periodic disclosure and continuous-disclosure systems, it is essential to draw a sharp line between duties to correct and duties to update.").

[14] The First, Second, Third, and Eleventh Circuits have recognized a possible "duty to update" theory of securities fraud. *See Backman v. Polaroid Corp.*, 910 F.2d 10, 16-17 (1st Cir. 1990) ("[I]n special circumstances, a statement, correct at the time, may have a forward intent and connotation upon which parties may be expected to rely. If this is a clear meaning, and there is a change, correction, more exactly, further disclosure, may be called for."); *In re Time Warner, Inc. Sec. Litig.*, 9 F.3d 259, 267 (2d Cir.1993) ("[A] duty to update opinions and projections may arise if the original opinions or projections have become misleading as the result of intervening events"); *In re Burlington Coat Factory Sec. Litig.*, 114 F.3d 1410, 1432 (3d Cir. 1997) ("For a plaintiff to allege that a duty to update a forward-looking statement arose on account of an earlier-made projection, the argument has to be that the projection contained an implicit factual representation that remained "alive" in the minds of investors as a continuing representation."); *Finnerty v. Stiefel Laboratories, Inc.*, 756 F.3d 1310, 1316-17 (11th Cir. 2014) ("We have held that a duty to disclose may arise from a defendant's previous decision to speak voluntarily. Specifically, a duty exists to update prior statements if the statements were true when made, but misleading or deceptive if left unrevised. There is, of course, no obligation to update a prior statement about a historical fact."). For the Ninth Circuit, *see Khoja v. Orexigen Therapeutics, Inc.*, 899 F.3d 988, 1015 (9th Cir. 2018), *cert. denied sub nom. Hagan v. Khoja*, 139 S. Ct. 2615 (2019) (finding that a company was obligated to disclose a later stage of pharmaceutical trial results because such disclosure "diminished the weight" of an earlier, true disclosure of preliminary results, though the court did not identify a "duty to update" theory).

[15] *In re Sanofi-Aventis Sec. Litig.*, 774 F. Supp. 2d 549, 562 (S.D.N.Y. 2011).

[16] *See In re Facebook, Inc. IPO Sec. & Derivative Litig.*, 986 F. Supp. 2d 428 (S.D.N.Y. 2013) ("Defendants still have a duty to correct statements that are false at the time they were made, when a Defendant learns that its prior statement is untrue.") (citation omitted); *Backman v. Polaroid Corp.*, 910 F.2d 10, 16-17 (1st Cir. 1990) ("[I]f a disclosure is in fact misleading when made, and the speaker thereafter learns of this, there is a duty to correct it"). *But see, e.g., In re Yahoo! Inc. Sec. Litig.*, 611 F. App'x 387, 389 (9th Cir. 2015) ("Neither the Supreme Court nor the Ninth Circuit has recognized a duty to correct.").

[17] *See Grossman v. Nowell, Inc.*, 120 F.3d 1112, 1125 (10th Cir. 1997) (rejecting a duty to correct when a prior statement was too vague and indefinite).

[18] *In re HealthCare Compare Corp. v. Sec. Litig.*, 75 F.3d 276, 282 (7th Cir. 1996) ("[P]laintiffs can only show that a duty to correct arose by alleging facts sufficient to demonstrate that the internal memorandum [in conflict with the alleged misstatement] was certain and reliable, not merely a tentative estimate.").

[19] *Higginbotham v. Baxter Int'l, Inc.*, 495 F.3d 753, 761 (7th Cir. 2007).

such concerns by explaining in its 8 April statement that, given the uncertainty created by COVID-19, the SEC "would not expect to second guess good faith attempts to provide investors and other market participants appropriately framed forward-looking information."[20] Some may view this statement as the SEC providing companies with some assurance that they will face no liability or less risk for SEC scrutiny for forward-looking disclosures related to COVID-19, but the potential for both SEC scrutiny and litigation exists. Companies must adhere to their past practice of ensuring that forward-looking statements are supportable. The SEC's statement also mentions potential "updates" and "refreshing" of such disclosures, which highlights additional risks and the potential for plaintiffs to bring civil claims based on duty to update or correct theories. These risks suggest that companies should be cautious about attempts to answer the SEC's call to provide more robust forward-looking statements about COVID-19's impact on a company's financials and business operations.

4. Risks for statements made outside of public filings

Companies may be at risk of SEC enforcement action based on the accuracy of statements made outside of their SEC filings. As of 14 April 2020, the SEC has ordered temporary suspensions of over a dozen companies for misleading or false statements to the public made by the companies or third-party promoters regarding the companies' ability to treat, prevent, or provide diagnostics relating to COVID-19.

Press releases and other public statements

For example, the SEC ordered a temporary suspension in the trading of securities of one company due to misleading statements it made in late February and early March press releases about having large quantities of N95 masks used to protect wearers from COVID-19 and being able to obtain more. Another company was the subject of a similar temporary suspension for a public announcement purporting it held international marketing rights to an approved treatment for COVID-19.

Statements promoted by third parties

One company was subject to a temporary suspension for activities of third-party promoters who were purportedly not affiliated with the company and who disseminated information to the public about the ability of the company's product to treat COVID-19.

5. Securities fraud class actions

Given the volatility of equities markets, we expect to see plaintiffs lawyers bring securities fraud putative class actions in the coming weeks and months related to COVID-19. For example, the following lawsuits were recently filed:

- In *Douglas v. Norwegian Cruise Lines*, filed on 12 March 2020 in the U.S. District Court for the Southern District of Florida, the plaintiff alleges, *inter alia*, that Norwegian misled investors by falsely touting the company's focus on health and safety of guests and crew amid the COVID-19 outbreak.
- In *McDermid v. Inovio Pharmaceuticals*, filed on 12 March 2020 in the U.S. District Court for the Eastern District of Pennsylvania, the plaintiff alleges, *inter alia*, that Inovio falsely claimed that it had developed a vaccine against the spread of COVID-19 that it anticipated bringing to market rapidly.

[20] SEC 8 April 2020 Statement.

- In *Brams v. Zoom Video Comms., Inc., et al.*, filed on 8 April 2020 in the U.S. District Court for the Northern District of California, the plaintiff alleges that Zoom misled investors by failing to disclose inadequate privacy and security measures that were not brought to light until the "impact of the COVID-19 pandemic," in which businesses increasingly relied on Zoom to facilitate remote working. A similar lawsuit was brought against Zoom by another plaintiff on 7 April 2020 in N.D. Cal. (*Drieu v. Zoom Video Comms., Inc., et al.*). This suggests that not only COVID-19 related disclosures, but COVID-19 prompted market conditions and business changes can form the basis for a putative securities class action.

As the situation regarding COVID-19 is constantly developing, please contact the authors of this article or other Hogan Lovells attorneys with whom you regularly work for additional information.

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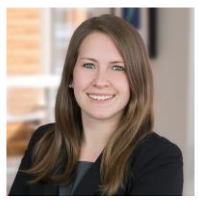

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