Insider Trading Policies and Procedures: A Refresher and Recent Developments

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Overview

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1 Refresher on Insider Trading Laws

What is Insider Trading and Who Can Be Liable?

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- "**Insider Trading**" generally is defined as:
  - trading in securities
  - while in possession of **material nonpublic** information (MNPI)
  - in **breach of a fiduciary duty** or other relationship of trust and confidence owed to the company, its stockholders or the source of information
- **Key Concepts**
  - Information is "**material**" when reasonable investors would consider it important in making an investment decision or when it could reasonably be expected to affect stock price
  - Information is "**nonpublic**" if it has not been disclosed broadly to the investing community (*e.g.*, through a press release or SEC filing) or the information has been disclosed but without a sufficient lapse of time for the market to absorb the information

Theories of Liability Developed by the Courts

- **Classical Theory** (Duty to Disclose or Abstain): trading in securities while in possession of MNPI that the insider obtained because of their corporate position
  - Duty applies to corporate insiders (officers, directors, controlling stockholders, employees) and temporary insiders (attorneys, accountants, consultants, underwriters and others who temporarily become fiduciaries)
  - Liability is premised on breach of fiduciary duty to corporation's stockholders
  - *Example*: A director of ABC Corp. learns at a board meeting that sales and net income for the most recently completed fiscal year declined by 10% from the prior year. Before ABC Corp. files its Form 10-K or issues its earnings release for the most recently completed fiscal year, the director sells half of the ABC Corp. shares he owns

Theories of Liability Developed by the Courts (cont'd)

- **Misappropriation Theory**: trading using MNPI obtained from people who had a duty to keep that information confidential
  - Theory covers the gap in "disclose or abstain"
    - *i.e.*, outsiders with access but no duty to stockholders
  - Liability is premised on duty to the information source
  - Rule 10b5-2 provides examples of circumstances in which a person has a duty of trust or confidence for purposes of the misappropriation theory of insider trading, including confidentiality agreements; where there is a history, pattern or practice of sharing confidences with reasonable expectation of confidentiality; and certain family relationships
  - *Example*: An employee of ABC Corp. learns that a major customer plans to terminate its contract to purchase products from ABC Corp. at the end of the month. This customer was responsible for generating 15% of the company's annual revenues. The employee tells her husband about the customer's plan, noting that the information is not yet public. Before ABC Corp. or the customer makes any public announcement about the termination of the contract, the husband sells all of the ABC Corp. shares he owns

Tipper/Tippee Liability

- Providing MNPI to outsiders who may trade on said MNPI is called **tipping**
- The person who receives that MNPI is a **tippee**
- Both the classical and misappropriation theories extend insider trading liability to tippees
  - A separate rule (Section 14(e) and Rule 14e-3 of the Exchange Act) also prohibits insider trading and tipping ahead of tender offers
- Tippee liability under "disclose or abstain" theory
  - A person who receives material nonpublic information from a corporate insider can be held liable for insider trading if the insider received a personal benefit, and thus breached his or her fiduciary duty to the issuer, by tipping the information, and the tippee knew or had reason to know of the breach
  - The personal benefit need not be pecuniary in nature (*e.g.*, reputation/gifts to family/friends)

Penalties and Consequences for Insider Trading

- Employees can be held liable in a variety of ways:
  - Criminal liability — fines and prison sentences of up to 20 years
  - SEC can seek disgorgement of profits gained or losses avoided
  - SEC can also seek civil penalties of up to three times the profit gained or losses avoided
  - Contemporaneous traders of the same securities as an insider trader can bring private actions against persons who trade on the basis of MNPI
  - Employees who violate a company's insider trading policy may also be subject to discipline by the company, generally up to and including termination of employment
- SEC can bring actions against persons who "control" individual securities laws violators, which may include:
  - Corporate employer
  - Employees with supervisory authority
  - Officers and directors of the employer
  - Controlling stockholders
  - Parent corporations
- Reputational harm

2 SEC Enforcement in "Shadow Trading"

Shadow Trading: *SEC v. Panuwat*

Background

- Matthew Panuwat worked at Medivation, a biopharmaceutical company, as a senior director of business development
- Medivation asked Panuwat to sign:
  - Confidentiality agreement
  - Insider trading policy
- From July to August 2016, Medivation solicited bids for a potential acquisition
- On August 18, 2016, Medivation's CEO emailed several employees, including Panuwat, stating that Pfizer expressed "overwhelming interest" in acquiring Medivation
  - Within seven minutes, Panuwat purchased 578 call options from Incyte, Medivation's competitor
- On August 20, Medivation signed a merger agreement with Pfizer
- On August 22, Medivation/Pfizer announced their merger and Incyte's stock rose
  - Panuwat profited $107,066 from his purchase

Shadow Trading: *SEC v. Panuwat*

Litigation

- On August 17, 2021, the SEC brought an action in California against Panuwat under the misappropriation theory, alleging:
  - Information about the merger constituted MNPI
  - Panuwat had a duty to Medivation under:
    1. Insider trading policy
    2. Confidentiality agreement
    3. General duty of trust and confidence to an employee
  - Panuwat's purchase of Incyte stock based on MNPI in the CEO's email breached his duty toward Medivation
- Panuwat challenged the SEC via a motion to dismiss and motion for summary judgment, but lost on both

Shadow Trading: *SEC v. Panuwat*

Material Nonpublic Information (MNPI)

Material

- Panuwat argued the Medivation merger was not material to Incyte
- Court reasoned that:
  - Information may be material to an issuer even if it originates elsewhere
  - Reasonable investor would have seen the two companies as comparable
  - Market value was driven by scarcity in this industry
  - Incyte's stock price increased following the merger announcement

Breach of a Duty

- Panuwat claimed that Medivation's insider trading policy did not prohibit trading Incyte's securities
- Court reasoned that:
  - The inside trading policy prohibited insider trading of other companies, such as Incyte
  - Medivation's confidentiality agreement prohibited misappropriation of company information
  - CEO entrusted Panuwat with information because he was an employee

Shadow Trading: *SEC v. Panuwat*

Trial

- The SEC presented each theory of liability, but focused primarily on the insider trading policy
- During trial, Panuwat testified that:
  - His trades were unrelated to information about the Medivation/Pfizer merger
  - He invested in Incyte to offset tax gains he made earlier in the year
- On April 5, 2024, a jury found Panuwat liable for insider trading, though it is unclear under which theory of liability

Shadow Trading: *SEC v. Panuwat*

Key Lessons – Scope

- Judge's reasoning is persuasive, not binding authority
- No higher court addressed shadow trading
- Panuwat focused on stock of competitors, but application could extend beyond:
  - Competitors
  - Business partners
  - Vendors

Shadow Trading: *SEC v. Panuwat*

Key Lessons – Differing Perceptions

- Broad company policies increase regulatory exposure by creating a larger duty on employees
  - Companies are torn on whether to adapt to regulatory developments given added risk for employees
- The SEC views the general duty of confidentiality as prohibiting misuse of information, irrespective of specific policies
- The SEC's interpretation of this case may be broader than the public's

Shadow Trading: *SEC v. Panuwat*

Key Lessons – Implementing Policies

- Narrow approach: Only restrict trading in the company based on MNPI
  - SEC may take issue with this and would provide less control over employee misuse of information
- Middle approach: Restrict trading in the company and other defined groups based on MNPI
- Broad approach: Restrict trading in any company based on MNPI
  - Difficult to implement and exposes employees to greater regulatory risk
- Companies can avoid issues by using existing controls:
  - Strict safeguards on MNPI
  - Information barriers
  - Restricted lists
  - Keeping information on a “need to know” basis

3 Disclosure Trends and Observations

Benchmarking Methodology

- 93 U.S. issuers in the S&P 500 index have filed a copy of their insider trading policy with Form 10-K as of November 17, 2024
  - Includes calendar year-end companies that voluntarily filed early through 2023 Form 10-K
- Reviewed whether and how policies address the following topics:
  - Company transactions in its own securities
  - Treatment of gifts
  - Shadow trading
  - Timing of blackout periods
  - Persons subject to blackout periods
  - Persons subject to pre-clearance requirement

Company Transactions in Its Own Securities

- Beginning with the 2024 Form 10-K for calendar year companies, Item 408(b)(1) of Reg. S-K requires 10-K or proxy statement disclosure of whether the company has adopted policies and procedures governing transactions in the company's securities by the company itself "that are reasonably designed to promote compliance with insider trading laws, rules and regulations, and any listing standards applicable to the registrant"
  - If a company has not adopted such policies and procedures, the company must explain why it has not done so
- Only two companies filed a stand-alone **repurchase policy** as an exhibit (McKesson and Proctor & Gamble)
- 89% are **silent** in the insider trading policy
- 8% address company trading in the insider trading policy

Treatment of Gifts

- In light of the SEC's increasing focus on potential abuses of gifts of securities, a growing number of companies have been treating gifts as "transactions" so they become subject to the same restrictions as open-market trades
- 69% treat gifts as transactions (*e.g.*, subject to blackouts, etc.)
- 14% carve out bona fide gifts (*e.g.*, may be permitted during blackouts, etc.)
  - Two companies provide certain conditions (*e.g.*, limited to charitable donations)
- 17% are silent on gifts

Shadow Trading

- 5% are silent on external trading
- 95% generally prohibit trading in securities of other companies based on MNPI
- Out of the policies that address shadow trading:
  - 68% generally limit to MNPI learned in the course of employment/service
  - 11% generally limit other companies to actual/potential business partners
  - 16% specifically reference competitors

Timing of Blackout Periods

- Blackout period should begin around the time that there is internal visibility of that quarter's financial results, depending on the company's specific circumstances
- Around 5-6% did not specify timing of quarterly blackout
- **Beginning of Blackout Each Quarter** (*i.e.*, closing of trading window)
  - 8%: End of second month (*e.g.*, November 30)
  - 4%: Beginning of third month (*e.g.*, December 1)
  - 39%: First half of third month (*e.g.*, December 2-15)
    - About half specified middle of third month (*e.g.*, December 15)
  - 30%: Second half of third month (*e.g.*, December 16-31)
    - 4 companies specified end of the quarter (*e.g.*, December 31)
  - 5%: Day after quarter end (*e.g.,* January 1)
  - 7%: Other (*e.g.,* 6 weeks or 30 days after end of blackout)

Timing of Blackout Periods (cont'd)

- **End of Quarterly Blackout** (*i.e.*, opening of trading window)
  - 66%: After one full trading/business day following earnings release
  - 5%: 24 hours after the earnings release
  - 17%: After two full trading/business days following earnings release
  - 7%: Other (*e.g.*, next trading day after earnings release)

Designated Insiders Subject to Quarterly Blackout Periods

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- Intended to capture certain insiders who have regular access to MNPI
- Best practice is to impose blackout restrictions to:
  - Directors
  - Section 16 officers
  - Other designated employees with regular access to MNPI, such as earnings information
- Level of detail of designated insiders varies by company
  - 90% companies refer to section 16 insiders and designated personnel
    - One company simply refers to anyone with access to MNPI
  - 9% subject blackout to all insiders (including all employees)
  - One company limited blackout to section 16 insiders

Persons Subject to Pre-Clearance Requirement

- Pre-clearance is intended to help minimize risk of insider trading
  - Also provides an opportunity to consider potential short-swing profit issues for Section 16 insiders
- 34% subject the blackout group to pre-clearance
- 26% limit pre-clearance to only section 16 insiders
  - One company requires prior notification instead of pre-clearance
- 38% also require pre-clearance for certain designated employees
- One company is silent on pre-clearance

4 Internal Compliance Processes

Q&A With Mac Stuckey

- Blackout periods and pre-clearance
- Response to shadow trading case
- Rule 10b5-1 plans
- Benchmarking

5 Other Developments in SEC Enforcement

10b5-1 Plans: *SEC v. Peizer & Acuitas Grp. Holdings, LLC*

Background

- Terren S. Peizer was the founder, executive chairman and chairman of the Board of Directors of Ontrak Inc., a California-based health care treatment company
- In May 2021, Mr. Peizer established a Rule 10b5-1 trading plan to sell Ontrak stock
  - The SEC alleged that, prior to May 2021, Mr. Peizer had learned that Ontrak's relationship with its then-largest customer — representing more than half of its revenue — was tenuous
- In August 2021, Peizer established a second Rule 10b5-1 trading plan to sell Ontrak stock
  - The SEC alleged that, Peizer was aware that the relationship with the customer was on the verge of being terminated
- When Ontrak announced on August 19, 2021, that the customer had terminated the contract, the company's stock price fell more than 44%
  - Peizer avoided more than $12.7 million in losses by executing the two trading plans
- In a parallel action, the DOJ brought criminal charges against Peizer
- In June 2024, a federal jury in California convicted Peizer for engaging in an insider trading scheme using Rule 10b5-1 trading plans

10b5-1 Plans: *SEC v. Peizer & Acuitas Grp. Holdings, LLC*

Key Lessons

- The SEC and DOJ pointed out that the investigation arose from a "data-driven initiative" into corporate executive trading pursuant to 10b5-1 plans
- Rule 10b5-1 is not an absolute defense. The affirmative defense is only available if:
  - The 10b5-1 plan was entered into before the person became aware of MNPI; and
  - The 10b5-1 plan was entered into in good faith and not as part of a plan or scheme to evade the prohibitions of the rule
- Companies are recommended to:
  - review and update insider trading policies to comply with the SEC's amendments to Rule 10b5-1
  - review and update 10b5-1 plans and processes, including the now-required cooling-off period, to confirm compliance with all conditions of Rule 10b5-1
  - provide and update comprehensive guidance to corporate executives regarding MNPI risks and 10b5-1 plans

Policies and Procedures Related to MNPI

- Investment advisers and broker-dealers under SEC scrutiny even in the absence of MNPI misuse
  - The SEC has charged investment advisers with violating Sections 204A and 206(4) of the Investment Advisers Act for failing to establish, maintain and enforce written policies and procedures reasonably designed to prevent the misuse of MNPI
    - *Sound Point Capital Mgmt.* (Aug. 2024) – SEC found that Sound Point, through its participation in an ad hoc lender group, became aware of negative developments concerning a borrower and, while possessing that MNPI, sold 2 CLO tranches with the loan
    - *Marathon Asset Mgmt* (Sept. 2024) – SEC found that Marathon did not have policies and procedures that spoke specifically to instances where it learned of MNPI through participation on ad hoc creditors' committees
  - The SEC has also charged broker-dealers with violating Section 15(g) of the Exchange Act for failing to establish, maintain and enforce written policies and procedures reasonably designed to prevent the misuse of MNPI
    - *SEC v. Virtu* (Jan. 2024) – proprietary traders "allegedly could observe" customer order execution data (with no indication that any did)

Presenter Biographies



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Kady Ashley is head of the firm's Mergers and Acquisitions Group in Washington, D.C. Her practice concentrates on M&A, private equity, general corporate and securities matters, and corporate governance. Ms. Ashley has represented buyers and sellers in public and private acquisitions and divestitures, stock and asset transactions, auctions, proxy fights, initial public offerings, and joint ventures and other strategic alliances. In the areas of general corporate and securities matters, Ms. Ashley advises clients on securities law compliance, disclosure issues and corporate governance matters. In addition, she counsels numerous clients on Rule 10b5-1 trading plans and practices and insider trading policies.

Ms. Ashley has been named to Chambers USA and The Deal's Women in Dealmaking list, honoring those who "are making an impact on the dealmaking community, advising on the most important transactions of the year in their field and taking a leadership role in promoting change." She has also been recognized with one of Corporate Counsel's 2024 Women, Influence & Power in Law (WIPL) Awards for demonstrating "a commitment to advancing the empowerment of women in law."



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Daniel Michael is co-head of Skadden's Web3 and Digital Assets Group. He represents corporations, as well as their boards of directors and executives, in connection with SEC and FINRA investigations and examinations. Mr. Michael regularly conducts internal investigations for clients and has advised companies on crisis management, regulatory analyses of current and prospective business operations, and the development and enhancement of policies and compliance-related controls. Prior to joining Skadden, Mr. Michael served as the chief of the SEC Enforcement Division's Complex Financial Instruments Unit (CFI), where he oversaw a nationwide team of attorneys and market specialists in investigations and enforcement actions involving complex financial products and market practices. Through his role at CFI and other high-level roles at the SEC, Mr. Michael developed an extensive understanding of issues involving complex financial instruments. In particular, he handled and supervised numerous matters concerning valuation, volatility, digital asset offerings, DeFi offerings and platforms, Regulation Best Interest and sales practices, security-based swaps, ESG disclosures and the SEC financial responsibility rules.

Mr. Michael has spoken and written extensively on SEC enforcement and white collar criminal matters and is the author of a quarterly column published by *Reuters* that focuses on regulatory issues relating to digital assets and blockchain technology.



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Caroline Kim concentrates her practice in the areas of public company reporting, corporate governance, mergers and acquisitions, and general corporate and securities matters. Ms. Kim advises clients on matters concerning Exchange Act reporting obligations, annual meetings of shareholders, insider trading, compliance with listing requirements of the New York Stock Exchange and Nasdaq, board independence, and environmental, social and governance reporting and related matters.

Prior to joining Skadden, Ms. Kim was an attorney at the U.S. Securities and Exchange Commission in the Division of Corporation Finance. She most recently served in the division's Office of Rulemaking, where she worked on various rulemaking initiatives, including the CEO pay ratio rules mandated under the Dodd-Frank Act. Previously, Ms. Kim was in the division's Office of Natural Resources, where she worked on transactional and securities compliance matters relating to the Securities Act and the Exchange Act, including IPO and business combination registration statements, proxy statements, periodic and current reports, and confidential treatment requests.



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As senior vice president, general counsel, and corporate secretary, Mac Stuckey leads CarMax's legal and compliance teams by providing best-in-class services to enable the company's strategic vision. He guides the department as it counsels CarMax across a wide range of substantive areas, including corporate governance, securities, litigation, finance and treasury, commercial transactions and M&A, labor and employment, store and customer experience center operations, product, marketing, data privacy, cybersecurity, compliance services, government affairs, and the Edmunds business.

Mr. Stuckey guided CarMax's first acquisition transaction, purchasing Edmunds in 2021. He also frequently engages with shareholders on corporate governance and responsibility matters. He served on The CarMax Foundation Board of Directors for 6 years, and as its president from 2014 to 2015. Prior to joining CarMax in 2004, Mr. Stuckey practiced securities and mergers and acquisitions law at Hunton & Williams, LLP (now Hunton Andrew Kurth LLP) and served a one-year term as a federal law clerk within the Western District of Louisiana. He received his Juris Doctor and Bachelor of Arts in History from the College of William & Mary.



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