

Testimony before the
Investor Protection, Entrepreneurship, and Capital Markets Subcommittee
U.S. House Committee on Financial Services
“Insider Trading and Stock Option Grants:
An Examination of Corporate Integrity in the Covid-19 Pandemic”

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September 17, 2020

Chairman Sherman, Ranking Member Huizenga and Members of the Subcommittee, it is an honor to participate in today’s hearing on Insider Trading and Stock Option Grants: An Examination of Corporate Integrity in the Covid-19 Pandemic. My name is Jill Fisch, and I am a professor at the University of Pennsylvania Law School where I teach and write in the areas of corporate law, corporate governance, and securities regulation. I also serve as the co-director of the Penn Institute for Law & Economics. Prior to joining the faculty at Penn, I taught at Fordham Law School for almost twenty years. Before that I worked as a corporate litigator in New York and in the criminal division of the U.S. Department of Justice.

In the past six months, the capital markets have experienced unprecedented levels of trading activity and price volatility.¹ The stock prices of many companies, particularly those in industries affected directly by the pandemic, including pharmaceutical companies, but also those involving the production of testing kits, personal protective equipment, internet-based services and even household supplies, have fluctuated dramatically. These fluctuations create the opportunity for manipulation and misconduct and have drawn considerable media attention.

I have written extensively about securities fraud, SEC enforcement and insider trading,² and I am happy to address the Subcommittee’s questions with respect to recent market events. At the outset, I want to be clear that I have not conducted any investigation or empirical analysis of the events at specific companies. Instead, I am here today to provide you with an overview of the existing regulatory structure and the challenges posed by the current market environment.

¹ SEC Chairman Jay Clayton has provided this Subcommittee with data on the high level of trading volume and volatility that the market has experienced in recent months. See Jay Clayton, Capital Markets and Emergency Lending in the COVID-19 Era, Testimony before the Investor Protection, Entrepreneurship, and Capital Markets Subcommittee U.S. House Committee on Financial Services, June 25, 2020 n. 2, available at <https://www.sec.gov/news/testimony/clayton-2020-06-25>.

² See, e.g., Jill E. Fisch, *Constructive Ambiguity and Judicial Development of Insider Trading*, 71 SMU L. Rev. 749 (2018); Jill E. Fisch, *Family Ties: Salman and the Scope of Insider Trading*, 69 Stan. L. Rev. Online 46 (2016); Jill E. Fisch, *Federal Securities Fraud Litigation as a Lawmaking Partnership*, 93 Wash. U. L. Rev. 453 (2016); Jill E. Fisch, *Start Making Sense: An Analysis and Proposal for Insider Trading Regulation*, 26 Ga. L. Rev. 179 (1991).

The activities in which I understand the Subcommittee to be interested involve three distinct sets of legal issues: disclosure integrity, the use of stock options and insider trading. I will address those issues in turn. I will briefly conclude by addressing the potential need for regulatory responses.

I. Disclosure Integrity

The first issue implicated by recent events is disclosure integrity. Some news stories have reported that issuers have made distorted, inaccurate or overly-optimistic disclosures in order to drive up their stock price for various reasons. Those reasons range from enabling insiders to sell their stock at a profit, increasing the value of executive stock options or facilitating the issuer's access to additional capital.

Existing securities regulation requires issuer disclosures to be accurate. False and misleading disclosures, particularly those that are made with the effort to manipulate stock prices or create opportunities for personal gain, constitute securities fraud.³ Accordingly, an issuer or corporate official that makes false claims about a pharmaceutical product that is under development or misstates the results of a clinical trial, has violated existing law and may face both an SEC enforcement action and private civil litigation. In addition, willful misstatements may subject the issuer and individual officials to criminal liability.⁴ Importantly, securities fraud liability attaches to all public statements, whether or not those statements are contained in a securities filing or addressed directly to the capital markets.

The existing market environment, however, creates a challenging disclosure environment for issuers. The scope of the pandemic, the global lockdown, and the effect on the world economy, are unprecedented. Any pandemic-related information has the potential to have an enormous impact. As a result, investors, capital markets, and the general public, are making tremendous demands on issuers to predict the future – to explain the potential effect of pandemic-related issues on their business operations. The SEC has encouraged issuers to provide as much information as possible about pandemic-related risks.⁵ At the same time, there are many unknowns. The medical and scientific communities are still in the process of developing information on how the virus spreads, how to treat it effectively and the potential time frame for existing research efforts. It is difficult for businesses to predict when they will be able to reopen, and the extent of consumer demand for services ranging from airline flights to face masks. It is equally hard to predict the cost of constantly-evolving regulatory restrictions, including measures designed to protect the health and safety of customers and employees. Simply put, issuers are under great pressure to disclose as much information as possible, in a constantly-changing environment, but premature disclosure may of uncertain forward-looking information may, in hindsight, prove inaccurate.

³ See 15 U.S.C. § 78j; 17 C.F.R. § 240.10b-5.

⁴ 15 U.S.C. § 78ff(a).

⁵ See, e.g., Coronavirus (COVID-19), Division of Corporation Finance, Securities and Exchange Commission, CF Disclosure Guidance: Topic No. 9, March 25, 2020, available at <https://www.sec.gov/corpfin/coronavirus-covid-19> (“The Division encourages timely reporting while recognizing that it may be difficult to assess or predict with precision the broad effects of COVID-19 on industries or individual companies.”).

At the same time, because the whole world is watching the effort to fight the pandemic, every disclosure, particularly in critical industries such as pharmaceuticals, has a dramatic effect on stock prices. Even an announcement that a company has made a small research advance is promising news, not just for investors, but for the world. Although some commentators have portrayed this price response as problematic, it is exactly the opposite. Investors evaluate issuers based on their future potential. In fact, it is socially desirable for capital to flow to issuers that offer the prospect of developing successful products – we call this allocational efficiency. An announcement that an issuer’s product has had success in an early stage trial, or that the issuer has demonstrated sufficient potential to obtain government funding are indications of the issuer’s potential future value and, as such, these announcements should cause stock prices to rise.

That is not to say that false announcements about research into treatments or vaccines are acceptable. As I said earlier, knowing, intentional and even reckless false statements are illegal and actionable. But particularly in this market environment, a significant stock price reaction to good news does not demonstrate fraudulent behavior, whether or not the company is ultimately successful in developing an effective product.

II. Stock Options

A few key points about the use of stock options. Stock options are a form of executive compensation. The grant of an option allows an executive to purchase stock at a future point in time at a pre-determined price, typically the current market price of the stock. The value of the option grant to the executive then is the difference between the grant price and the price at the time that the option is exercised. When the option is exercised, the executive purchases the stock from the corporation, not from public investors. As a result, the cost to the corporation from an option grant is no different than if the executive were paid the same amount in the form of a salary or bonus.⁶ The primary rationale for using options is that they are performance-based; the executive only makes money if the stock price increases.⁷

As executive compensation, stock options are also subject to certain structural requirements. Contrary to some suggestions by the media, corporate executives cannot simply award themselves stock options. For a publicly-traded corporation, the compensation committee of the Board of Directors, a committee consisting of independent directors, must approve both the amount and structure of executive compensation. In some cases, option grants are also subject to shareholder approval. Existing securities laws require extensive disclosure of the compensation of an issuer’s top executives, and the Dodd-Frank Act implemented “Say on Pay,” a requirement that the shareholders be given an opportunity to cast a non-binding vote approving the issuer’s compensation plan.⁸

⁶ At one point, issuers could obtain more favorable accounting treatment by compensating executives with options rather than other forms of compensation. That possibility was eliminated by the adoption of a requirement that issuers expense stock option grants. See David I. Walker, *Reconsidering Realization-Based Accounting for Equity Compensation*, 13 N.Y.U. J.L. & Bus. 535 (2017).

⁷ Regulators and investors have increased encouraged issuers to incorporate performance-based metrics into their executive compensation structures.

⁸ Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 951, 124 Stat. 1376 (2010) (codified at 15 U.S.C. § 78n-1).

Because of this structure, an executive who is granted a stock option is not engaging in insider trading. The situation is no different than if, in expectation of receiving government funding or FDA approval, a pharmaceutical company awarded its executives salary increases or bonuses. There is no requirement that, in making compensation decisions, the Board disclose material non-public information, nor is there any rationale for such a requirement, as there is no need to protect the interests of an uninformed market counterparty. State corporate law imposes fiduciary duties on the directors who approve a stock option grant, however, and federal law requires accurate disclosure of the terms of the options and the date upon which they are granted.⁹

The use of option-based compensation does create a degree of moral hazard. The schedule on which options are granted, vest, and can be exercised may create strong financial incentives for executives to control the timing of the issuer's disclosures in order to generate profitable trading opportunities. Federal securities law attempts to limit this type of opportunistic behavior both by requiring disclosure when executives trade their company's stock¹⁰ and by providing that short-swing trading profits – profits based on a purchase and sale within a six month period, must be forfeited to the corporation.¹¹ These provisions do not require proof that the executive was privy to or misused material non-public information.

III. Insider Trading

The final concern is the possibility of insider trading. Congress has never defined insider trading by statute, although there have been many bills introduced with proposed definitions. Of those bills, H.R.2534 does an excellent job of synthesizing the existing case law, establishing clear standards for what constitutes the wrongful acquisition or use of material nonpublic information, and increasing predictability. There are, however, advantages and disadvantages to promulgating a statutory definition in that it may inhibit the law's ability to adapt to future practices and market conditions. There is also little reason to believe that the conduct that has been the focus of the media attention falls within a grey area of existing law. If corporate executives purchased or sold securities ahead of material public disclosures, their actions were illegal. Indeed, it appears that a fair amount of the media attention has focused on corporate executives who sold their existing holdings **following** a public disclosure, a disclosure that resulted in a substantial increase in stock price. This does not constitute insider trading.

There is, however, a component of discretionary executive trading behavior that is potentially problematic, and that is the use of 10b5-1 plans.¹² The purpose of such plans is to enable an executive to establish a plan to buy or sell stock in advance of acquiring any material nonpublic information. Once a plan is in place, the trades can occur even if, at the time of the trade, the executive is in possession of inside information. 10b5-1 plans allow executives to obtain liquidity by selling stock that they have received as compensation on a regular basis without triggering insider trading liability in connection with those sales.

⁹ These disclosure requirements were at the heart of the options back-dating scandals.

¹⁰ 15 U.S.C. § 78p(a).

¹¹ 15 U.S.C. § 78p(b).

¹² 17 C.F.R. § 240.10b5-1.

A shortcoming of the existing regulatory structure is that current law does not require corporate executives to disclose the existence of their 10b5-1 trading plans. Nor are executives required to disclose if they modify or terminate an existing plan. In addition, current law allows executives, in some cases, to modify existing trading plans on the basis of inside information without facing liability for insider trading. Specifically, an executive who learns about positive news can terminate his or her previously established decision to sell, based on that news. Because the termination does not constitute the purchase or sale of a security, but rather refraining from trading, technically it is not insider trading. It appears that some executives, in light of market developments may have decided not to trade in accordance with their existing 10b5-1 plans. Although individual issuers may establish procedures governing when or how executives are permitted to do so, such procedures are not required by existing law.

IV. Potential regulatory responses

Finally, a few words about potential regulatory reforms. As I indicated, existing law clearly prohibits corporations and corporate executives from making false statements to manipulate stock prices, whether or not they do so with the intention of creating profitable trading opportunities. The law does not, however, prohibit corporate executives from profiting when stock prices rise in response to accurate positive information, even if that information is speculative and even if the market is over-reacting to the news.

The use of stock options and the use of stock price as a metric for executive performance increase the probability that corporate executives will enjoy substantial gains if the price of their company's stock increases – and there have been many recent examples of such gains in both the pharmaceutical industry and elsewhere. It may be bad corporate policy to pay executives too much or to structure their compensation to be so heavily depend on stock price movements, and the practice may be problematic from a governance perspective, but that does not make it insider trading or securities fraud.

The potential for corporate executives to behave opportunistically through their use of 10b5-1 trading plans is another matter. The capital markets would benefit from greater disclosure requirements surrounding the use of 10b5-1 plans so that they do not serve as a cover for the misuse of information. Similarly, it is a matter of good corporate hygiene for corporate boards to set policies to monitor the circumstances under which executives establish, modify and terminate such plans.

Thank you, Chairman Sherman and Ranking Member Huizenga, for inviting me to participate in today's hearing, and I look forward to your questions.