

September 14, 2020

Memorandum

To: Members, Committee on Financial Services

From: FSC Majority Staff

Subject: September 17, 2020, “Insider Trading and Stock Option Grants: An Examination of Corporate Integrity in the Covid-19 Pandemic.”

The Subcommittee on Investor Protection, Entrepreneurship, and Capital Markets will hold a hearing entitled, “Insider Trading and Stock Option Grants: An Examination of Corporate Integrity in the Covid-19 Pandemic,” on Thursday, September 17, 2020, at 12:00 p.m., on the virtual meeting platform Cisco Webex .This single-panel hearing will have the following witnesses:

- **Rick Claypool**, Research Director, Office of the President, Public Citizen
- **Jill Fisch**, Distinguished Professor of Business Law and Co-Director of the Institute of Law and Economics, University of Pennsylvania Law School
- **Jacob S. Frenkel**, Chair of Government Investigations and Securities Enforcement, Dickinson Wright
- **Granville Martin**, Senior Vice President and General Counsel, Society for Corporate Governance

I. Purpose

Over 190,000 Americans have lost their lives in the coronavirus disease 2019 (COVID-19) pandemic. As development of the COVID-19 vaccine continues, media reports indicate that pharmaceutical company insiders have personally profited from announcements related to their affiliation with the Trump Administration’s Operation Warp Speed (OWS),¹ a program the President launched earlier this year.² Similarly, other insiders profited by announcing a letter of interest (LOI), signed as an initial step towards the company receiving a loan under to the President’s May 14, 2020 Executive Order

¹ See, e.g., The New York Times, *Corporate Insiders Pocket \$1 Billion in Rush for Coronavirus Vaccine*, July 25, 2020, <https://www.nytimes.com/2020/07/25/business/coronavirus-vaccine-profits-vaxart.html>.

² See Factsheets, *President Trump Is Leading a Once-in-a-Generation Effort to Ensure Americans Have Access to a COVID-19 Vaccine*, (July 27, 2020), available at <https://www.whitehouse.gov/briefings-statements/president-trump-leading-generation-effort-ensure-americans-access-covid-19-vaccine/#:~:text=Earlier%20this%20year%2C%20President%20Trump,deliver%20vaccines%20in%20record%20time> (as of Sept. 9, 2020).

(Executive Order).³ Those profits have been recognized in various forms, including stock option awards and personal securities transactions.⁴ This hearing will examine the use of such compensation schemes and the state of corporate integrity during the COVID-19 pandemic.

II. Insider Trading and Stock Options Awards

A. Insider Trading

There is no Federal statute defining “insider trading” — the law of insider trading has been developed on a case-by-case basis by the courts over several decades, and insider trading is prosecuted under the general securities fraud section of the Securities Exchange Act of 1934.⁵ The general fraud section prevents market participants from using or employing any manipulative or deceptive devices when trading securities.⁶ Insider trading would constitute manipulative or deceptive devices and, in general, refers to undisclosed trading on material, nonpublic corporate information by individuals who are under a duty of trust and confidence that prohibits them from using such information for their own personal gain.⁷ In the context of insider trader, employee stock options present a peculiar dilemma.

B. Spring-Loading Options

Employee stock options give recipients the *option* to buy or sell company stock. When stock options are intentionally issued before a public announcement that will increase the company’s share price, this is referred to as “spring-loading.”⁸ By granting executives stock options shortly before a major public announcement, or timing a public announcement to occur just after the granting of stock options, the options may increase in value. Companies who engage in spring-loading options may not be guilty of insider trading, unless the option holder buys or sells company shares while in possession of material

³ See, e.g., The Daily Mail, *Kodak CEO admits he bought thousands of shares in the fallen photo firm AFTER taking part in secret talks to turn company into pharma giant with \$768M government loan - making \$1.5m personal profit* (July 30, 2020), available at <https://www.dailymail.co.uk/news/article-8576731/Kodak-CEO-admits-talks-turn-photo-giant-pharma-company-began-month-bought-shares.html> (as of Sept. 1, 2020). By Executive Order, dated May 14, 2020, the President of the United States delegated authority, under the Defense Production Act of 1950, as amended, to the US International Development Finance Corporation (DFC). Pursuant to that delegated authority, DFC may, in consultation with other federal agencies, lend money to companies “for the domestic production of strategic resources needed to respond to the COVID-19 outbreak, or to strengthen any relevant domestic supply chains.” See EO on Delegating Authority Under the DPA to the CEO of the U.S. International Development Finance Corporation to Respond to the COVID-19 Outbreak (May 14, 2020), available at <https://www.whitehouse.gov/presidential-actions/eo-delegating-authority-dpa-ceo-u-s-international-development-finance-corporation-respond-covid-19-outbreak/> (as of Sept. 1, 2020).

⁴ See, e.g., The New York Times, fn. 1, *supra*, available at <https://www.nytimes.com/2020/07/25/business/coronavirus-vaccine-profits-vaxart.html>; Financial Post, *How Moderna execs are cashing in on COVID-19 vaccine stock speculation*, (July 2, 2020), available at <https://financialpost.com/pmn/business-pmn/how-moderna-execs-are-cashing-in-on-covid-19-vaccine-stock-speculation> (as of Sept. 01, 2020); The Daily Mail, fn. 2, *supra*, available at <https://www.dailymail.co.uk/news/article-8576731/Kodak-CEO-admits-talks-turn-photo-giant-pharma-company-began-month-bought-shares.html> (as of Sept. 1, 2020).

⁵ Section 10(b) of the Exchange Act [15 U.S.C. § 78j(b)]; 17 C.F.R. § 240.10b-5. See also *United States v. Newman*, 773 F.3d 438, 445 (2d Cir. 2014) (“Although Section 10(b) was designed as a catch-all clause to prevent fraudulent practices, ... neither the statute nor the regulations issued pursuant to it, including Rule 10b-5, expressly prohibit insider trading. Rather, the unlawfulness of insider trading is predicated on the notion that insider trading is a type of securities fraud proscribed by Section 10(b) and Rule 10b-5.”) (internal citations omitted).

⁶ Section 10(b) of the Exchange Act [15 U.S.C. § 78j(b)]; 17 C.F.R. § 240.10b-5.

⁷ Id; see also, *Chiarella v. United States*, 445 U.S. 222, 226–230 (1980); *Dirks v. SEC*, 463 U.S. 646, 653–654 (1983); *Salman v. United States*, No. 15-628, *slip op.* at 1 (2016); *In re Cady, Roberts & Co.*, 40 S.E.C. 907 (1961).

⁸ Financial Times, *Options Spring-Loading Stirs SEC controversy* (July 6, 2006), available at <https://www.ft.com/content/f089b976-0d43-11db-84fd-0000779e2340> (as of Sept. 1, 2020).

nonpublic information. Empirical analysis indicates that public company CEOs have appeared to manipulate stock prices to increase compensation through the granting of stock options.⁹

C. Trading Plans Under SEC Rule 10b5-1

Employers may also buy or sell securities pursuant to a trading plan under SEC Rule 10b5-1.¹⁰ SEC Rule 10b5-1, ostensibly, exists as a safe harbor, in that insiders who purchase or sell company securities under a qualified 10b5-1 trading plan will have an affirmative defense to insider trading.¹¹ One requirement of SEC Rule 10b5-1 is that qualified plans must be entered into when the insider is not in possession of material nonpublic information.¹² Revisions to the plan must also be completed while the insider is not in possession of material nonpublic information.¹³

III. Corporate Integrity and Profiteering in the COVID-19 Pandemic

A. Novavax, Inc.

The Trump Administration's OWS awarded \$1.6 billion to Novavax, Inc. (Novavax), a small pharmaceutical company that, reportedly, had not brought a single vaccine to market throughout its entire 33-year history.¹⁴ Novavax stock, which had been trading at less than \$4 per share at the start of the year, soared to almost \$190 per share by August.¹⁵ The small pharmaceutical company awarded its executives stock options that would pay out even if the company fails to bring a vaccine to market.¹⁶ Executives would be able to exercise those options a year after the company starts a Phase 2 trial.¹⁷ Commencing a Phase 2 trial does not guarantee that the vaccine will make it to market.¹⁸ As of late July, Novavax's CEO, Stanley Erck, and three other Novavax executives, stood to earn options that were reportedly worth \$101 million.¹⁹ Last month, Novavax insiders also sold 172,979 Novavax shares, worth almost \$17 million.²⁰

⁹ See, generally, Journal of Financial and Quantitative Analysis v. 53, No. 3 (June 2018), *Right on Schedule: CEO Option Grants and Opportunism*, available at <https://www.cambridge.org/core/journals/journal-of-financial-and-quantitative-analysis/article/right-on-schedule-ceo-option-grants-and-opportunism/DA0C243E4AE7E58B78D2E20E78520A9A/share/f9663ff7226e5992e78e2f25ad6301d6f6105b2a#pf22>.

¹⁰ 17 C.F.R. § 240.10b5-1.

¹¹ 17 C.F.R. § 240.105-1 (c).

¹² 17 C.F.R. § 240.105-1(c)(1)(i)(A).

¹³ 17 C.F.R. § 240.105-1(c)(1)(i)(A)(3).

¹⁴ See New York Times, *How a Struggling Company Won \$1.6 Billion to Make a Coronavirus Vaccine*, (July 16, 2020) available at <https://www.nytimes.com/2020/07/16/health/coronavirus-vaccine-novavax.html> (as of Sept. 9, 2020).

¹⁵ See Washington Business Journal, *Novavax execs cash out on stock buoyed by Covid-19 vaccine work*, (Aug. 21, 2020), available at <https://www.bizjournals.com/washington/news/2020/08/21/novavax-execs-cash-out-stock-buoyed-by-covid-19-va.html> (as of Sept. 11, 2020).

¹⁶ See, Reuters, *Exclusive: Novavax executives could get big payday even if vaccine fails*, (July 22, 2020), available at <https://www.reuters.com/article/us-health-coronavirus-novavax-compensati/exclusive-novavax-executives-could-get-big-payday-even-if-vaccine-fails-idUSKCN24N1G> (as of Sept. 11, 2020).

¹⁷ Id.

¹⁸ Id.

¹⁹ Id.

²⁰ See Washington Business Journal, fn. 15, *supra*, available at <https://www.bizjournals.com/washington/news/2020/08/21/novavax-execs-cash-out-stock-buoyed-by-covid-19-va.html> (as of Sept. 11, 2020).

B. Moderna, Inc.

After announcing its progress towards a COVID-19 vaccine, Moderna, Inc.'s (Moderna's) stock price increased by over 24%²¹ and certain Moderna executives, reportedly, altered their 10b-5-1 trading plans to increase the number of company stocks they could sell.²² As noted above, a 10b-5-1 trading plan is a predetermined written plan under which executives and insiders make purchases and sales of company stock. Trading activity done in accordance with a qualifying 10b-5-1 plan may be used as an affirmative defense to insider trading.²³

Media reports indicate that, by altering his plan, Moderna's CEO sold 72,000 company shares, for a \$4.8 million profit.²⁴ Reports also indicate that Moderna's President altered his trading plan to allow him to sell \$1.9 million in company shares, even though he, previously, did not have any preplanned sales for the applicable time period.²⁵

C. Eastman Kodak Company

On July 28, 2020, U.S. International Development Finance Corporation (DFC) announced that, pursuant to the Executive Order, it would sign a LOI to loan \$765 million to Eastman Kodak Company (Kodak).²⁶ That loan would allow Kodak to launch a new company that would "produce critical pharmaceutical components."²⁷ On June 23, 2020, before the LOI was announced, Kodak's CEO bought 46,737 of Kodak stock.²⁸ On the same day, a member of Kodak's board purchased 5,000 company shares.²⁹ These shares would increase in value by more than 1000 percent, after the LOI was announced³⁰ and the June 23, 2020 purchase, alone, could have yielded a reported \$1.5 million profit for Kodak's CEO.³¹

The day before the LOI was announced, Kodak's board also, reportedly, issued its CEO \$1.75 million stock options.³² This would allow him to purchase Kodak shares "at prices ranging from \$3.03 to \$12."³³ According to media reports, based on the increased value of these shares after the LOI announcement,

²¹ Financial Post, fn. 3, *supra*, available at <https://financialpost.com/pm/business-pmn/how-moderna-execs-are-cashing-in-on-covid-19-vaccine-stock-speculation> (as of Sept. 01, 2020).

²² CBS News, *Moderna executives hiked their stock sales after announcing positive vaccine trial* (July 21, 2020), available at <https://www.cbsnews.com/news/moderna-executives-increased-stock-sales-after-coronavirus-vaccine-trial-data/#:~:text=Moderna%20executives%20hiked%20their%20stock%20sales%20after%20announcing%20positive%20vaccine%20trial,-By%20Stephen%20Gandel&text=Moderna%20CEO%20St%C3%A9phane%20Bancel%20more.results%20for%20its%20coronavirus%20vaccine> (as of Sept. 01, 2020).

²³ 17 CFR 240.10b5-1.

²⁴ See CBS News, fn. 22, *supra*.

²⁵ *Id.*

²⁶ DFC to Sign Letter of Interest in Investments for Kodak's Expansion Into Pharmaceuticals (July 28, 2020), available at <https://www.dfc.gov/media/press-releases/dfc-sign-letter-interest-investment-kodaks-expansion-pharmaceuticals> (as of Sept. 1, 2020).

²⁷ *Id.*

²⁸ Daily Mail, fn. 2, *supra*, available at <https://www.dailymail.co.uk/news/article-8576731/Kodak-CEO-admits-talks-turn-photo-giant-pharma-company-began-month-bought-shares.html> (as of Sept. 1, 2020).

²⁹ *Id.*

³⁰ The New York Times, *Kodak C.E.O. Got Stock Options Day Before News of Loan Sent Stock Soaring*, available at <https://www.nytimes.com/2020/07/31/business/kodak-ceo-stock-options.html> (as of Sept. 1, 2020).

³¹ Daily Mail, fn. 2, *supra*, available at <https://www.dailymail.co.uk/news/article-8576731/Kodak-CEO-admits-talks-turn-photo-giant-pharma-company-began-month-bought-shares.html> (as of Sept. 1, 2020).

³² The New York Times, fn. 30, *supra*, available at <https://www.nytimes.com/2020/07/31/business/kodak-ceo-stock-options.html> (as of Sept. 1, 2020).

³³ *Id.*

these options could have been worth \$50 million in late July.³⁴ Kodak's share price eventually declined amidst allegations of insider trading and after DFC announced its decision to put the loan on hold.³⁵

Legislation:

- **H.R. 624, Promoting Transparent Standards for Corporate Insiders Act (Waters):** this bill directs the Securities and Exchange Commission (SEC) to study and report on possible revisions to regulations regarding Rule 10b5-1 trading plans. (Such plans allow certain employees of publicly traded corporations to sell their shares without violating insider trading prohibitions.) The SEC must revise regulations consistent with the results of the study.
- **H.R. 2534, Insider Trading Prohibition Act of 2019 (Himes):** to amend the Securities and Exchange Act of 1934 to prohibit certain securities trading and related communications by those who possess material, non-public information.
- **H.R. 4335, 8-K Trading Gap Act of 2019 (Maloney):** this bill would direct the SEC to issue a rule requiring public companies to put in place policies and procedures that are reasonably designed to prohibit officers and directors from trading company stock after the company has determined that a significant corporate event has occurred, and before the company has filed a Form 8-K disclosing such event.
- **H.R.____, to amend the Securities Exchange Act of 1934 to prohibit issuers from granting stock options if the grantor or recipient are in possession of certain nonpublic information, and for other purposes (Sherman):** this bill would impose certain restrictions on issuers granting stock options to any officer, employee, or director if the issuer is in possession of material nonpublic information.

³⁴ Id.

³⁵ Market Insider, *Kodak share price crashes over 30% after US government loan for \$765 million gets put on ice*, (Aug. 10, 2020), available at https://markets.businessinsider.com/news/stocks/kodak-stock-price-crashes-reports-765m-loan-gov-hold-2020-8-1029487105?utm_source=markets&utm_medium=ingest# (as of Sept. 1, 2020).