

SEC Enforcement Focus on Fallout from COVID-19: Insights for Public Companies and Investment Advisers During a Crisis

Client Alert | March 26, 2020

In a warning of things to come, the co-directors of the SEC Enforcement Division took the unusual step of issuing a cautionary statement on March 24, 2020, emphasizing “the importance of maintaining market integrity and following corporate controls and procedures” during this crisis. The SEC cited as examples the heightened risk of insider trading (“in these dynamic circumstances, corporate insiders are regularly learning new material nonpublic information that may hold an even greater value than under normal circumstances”) and the need to be mindful of disclosure controls (“protect against the improper dissemination and use of material nonpublic information”).^[1]

History teaches us that unprecedented market volatility, fast moving economic events, and dislocations create substantial challenges for compliance, *and* that there is a significant increase in the risk of an investigation. Today, this heightened investigative risk is compounded by unique challenges of remote work arrangements and the diminished ability for direct oversight and interaction.

In an effort to help our clients navigate the latest enforcement challenges, we have compiled below a list of potential issues to be considered in the coming weeks in light of the SEC Enforcement Division’s notice and past experience on how the SEC has investigated matters in the midst of and following a crisis.

General Guidance

1. Businesses should be prepared to operate under these conditions for at least the next three-to-six months.
2. Businesses should maintain centralized communications with employees, clients, and investors, ensuring that even in the face of rapidly moving events that such communications are accurate and complete. Once statements are made, updates and modifications may become appropriate.
3. Given the compliance and operational challenges of supervising employees and service providers remotely, it is helpful to have a plan in place for such supervision.

Business Continuity and Disaster Recovery Plans

Firms should follow, and modify as necessary, their business continuity and disaster recovery plans. During and after past crises, the SEC’s Office of Compliance Inspections and Examinations, FINRA, and the CFTC have jointly and separately reviewed the business continuity and disaster recovery planning of firms, especially in the event of a problem experienced during the crisis.

Material Contracts

Related People

[Mark K. Schonfeld](#)

[Reed Brodsky](#)

[Barry Goldsmith](#)

[Gregory Merz](#)

[C. William Thomas, Jr.](#)

[Ronald O. Mueller](#)

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It is important to review material contracts to understand what would happen if your business or a counterparty cannot perform due to the current crisis. In particular, we recommend focusing on the (i) default, (ii) force majeure, (iii) termination and (iv) indemnification provisions in material contracts. For more information, see our alerts: [Force Majeure Clauses: A 4-Step Checklist and Flowchart](#)^[2] and Coronavirus and [Force Majeure: Addressing Epidemics in LNG and Other Commodities Contracts](#).^[3]

Regulatory Disclosures

As always, consider if the current crisis has materially affected your business and if, when and how those events may need to be disclosed and if any recent statements need to be updated. There is an enhanced investigative risk that regulators will in hindsight review a business' public statements and disclosures to determine whether a firm intentionally and materially overstated, understated, failed to correct prior statements, and/or made misleading or incomplete statements, in light of crisis-related events

Public Company Considerations

Fair Disclosure, Regulation FD

Pursuant to Regulation Fair Disclosure ("Regulation FD"), in general, issuers cannot selectively disclose material, nonpublic information to stock analysts, investment advisors, security holders, or other market participants, and must disclose such information to that audience by means of simultaneous broad public dissemination.^[4] Given that this crisis may have a short-term, material impact on an issuer's finances and business operations, among other things, it is important to make sure that the process of communicating these developments with shareholders, analysts, media and other stakeholders is consistent with public disclosures and monitored with Regulation FD in mind. Sensitivity to the requirements of Regulation FD is critical in light of the extreme market volatility and the desire of market participants for information during the current COVID-19 crisis.

Insider Trading and Trading Windows

Public issuers should evaluate and potentially modify established trading windows during this crisis as rapidly evolving materials events may render historical trading windows inadequate. For example, during the exigency of evolving events, material nonpublic information may quickly arise outside of the traditional blackout periods, requiring the imposition of immediate restrictions on trading for certain groups of employees, executives and directors. Moreover, media reporting on notable stock sales by corporate executives heightens the exposure to regulatory inquiry. In limited instances, blackout periods might be shortened if it is in the best interests of the company and its shareholders to enable trading, and there is no material, nonpublic information due to uncertainty around how the situation is affecting the company; however, during a crisis such as this, care should be taken not to improperly restrict the communication of material information, particularly to directors and others that may need to know such information in order to perform their duties. Any changes to blackout periods must be based on the specific facts and circumstances, and should be communicated in writing with appropriate guidelines. As a general matter, public companies should exercise care in allowing corporate insiders to trade in its securities (both buying and selling) during the current crisis.

10b5-1 Plans

Pursuant to Rule 10b5-1, corporate insiders frequently set up passive investment plans at a time when they do not have material, nonpublic information, in order to provide a mechanism to purchase and sell securities of their company when they have material, nonpublic information.^[5] In a time of crisis, there is risk that any changes to such plans which continue to involve trading in the issuer's securities will be scrutinized carefully by regulators, the media, and others as to whether they were made while in possession of

material, nonpublic information about the effect of the crisis on the relevant issuer and to take advantage of such knowledge. Terminating a Rule 10b5-1 plan so as to cease any trading of securities in this time of crisis does not in and of itself violate the insider trading laws, and there may be very good reasons to do so. While the extraordinary changes in the markets and economy resulting from the COVID-19 situation may provide a basis for defending past transactions under a Rule 10b5-1 plan as having been made in good faith, terminating a Rule 10b5-1 plan may bear on the timing of any future decision to set up a new plan. Before making any changes to and/or stopping such a plan, corporate insiders and companies should consult their general counsel's office and consider the best practices under the circumstances.

Investment Adviser Considerations

Insider Trading

During a crisis, reminding investment professionals about the policies and procedures to prevent insider trading is critically important. There is a heightened investigative risk that communications with management and investor relations, which are a standard and proper part of an investment professional's analyses of companies, regarding COVID-19 will be reviewed, in hindsight, for any disclosures of material, nonpublic information. There is also a heightened investigative risk that communications with political experts, members of federal and state executive branches and their agencies, and the staff of public representatives regarding ongoing executive and legislative actions, and the application of new laws and regulations, will be reviewed, in hindsight, for any disclosures of material, nonpublic information in violation of a fiduciary and/or other duty of confidentiality. Finally, there is a heightened investigative risk that communications with other asset managers regarding their analyses of the impact of COVID-19, which include communications, directly or indirectly, with management, investor relations, political experts, members of the executive branch, and staffs of public representatives, will be evaluated, in hindsight for any disclosures of material, nonpublic information.

Investment Strategy Changes

Certain investment strategies may be materially impaired by this current crisis or advisers may find unique opportunities outside of their traditional strategies. Under such circumstances, it is important to, among other things, review the documents governing the strategies to identify what changes fall within and outside such strategies, and what steps, if any, should be taken to make modifications to those strategies.

Unique Opportunity Allocations

Given market volatility during a crisis, unique investment opportunities may arise. Investment advisers may have to consider how to allocate unique opportunities amongst their funds, accounts and potential co-investors. As always, an adviser's personnel will need to follow the adviser's policies and procedures designed to ensure that they do not personally take investment opportunities away from funds and accounts managed by the adviser.

Form ADV/Form PF Limited Relief

For investment advisers, limited SEC relief for Form ADV/Form PF filing deadlines is available for those advisers experiencing crisis-related issues. Updated SEC guidance issued on March 25, 2020, provided that advisers "must notify the [SEC] staff and/or investors, as applicable, of the intent to rely on [such] relief, but generally no longer need to describe why they are relying on the order or estimate a date by which the required action will occur." We nonetheless encourage advisers to file timely unless they are experiencing serious crisis-related issues, and to the extent an adviser must seek deadline relief, internally document reasons for failing to timely file. [\[6\]](#)

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Custody Rule Relief

The SEC has not yet granted specific relief to the audited financial statement delivery requirement under the Rule 206(4)-2.^[7] and advisers should try to meet their delivery requirements. Notably, in March 2010, an SEC Division of Investment Management FAQ stated that it would not recommend enforcement if an adviser “reasonably believed that the pool’s audited financial statements would be distributed within the 120-day deadline, but failed to have them distributed in time under certain unforeseeable circumstances.”^[8] It is not clear whether the Staff would consider this interpretive guidance to apply to a failure to deliver financial statements on time due to disruptions relating to COVID-19. Nevertheless, in the absence of relief related to the specific crisis, the Staff might be less inclined to bring an action against advisers making reasonable efforts to comply with the delivery requirement.

Investor Communications

Approaches will vary, but consider proactively advising investors of the steps you are taking to maintain operations and whom to contact with questions or concerns. Performance and investment risk discussions should include discussions of the impact this current crisis may have on investments. Under any approach, advisers should continue to maintain records of communications with investors and other stakeholders, together with any secondary support for information distributed. For funds raising capital or that permit redemptions, updates to offering materials may be appropriate. Selective disclosure to investors should be avoided.

Valuation

Throughout this crisis, advisers should continue to follow their valuation policies, and this could be a good time to remind relevant personnel of the details of such policies. While following existing policies is important, personnel should consider reassessing valuation assumptions and methodologies in consideration of the current environment. Decisions about changes to valuations relating to distressed asset sales should be made in consultation with experts and compliance.^[9] Finally, we recommend taking additional time for the valuation process (*i.e.*, starting earlier) and potentially conducting valuations more frequently.

Liquidity Management

Certain open-ended funds may experience a high volume of requests for redemptions, and advisers may have challenges in satisfying all requests in a timely fashion. An adviser facing this type of risk should carefully assess options under the applicable fund or account documents, including the possibility of imposing redemption gates, side pockets or suspensions. Implementing these types of measures may draw regulatory scrutiny in retrospect, and should be handled with care.

If an adviser intends to seek liquidity through a related party transaction or a forced sale, the adviser should carefully consider the legal and regulatory issues that can be raised by these actions.

Side Letter and Strategic Partnership Obligations

Side letters or strategic partnership agreements may have notice or redemption rights that are implicated by the current crisis, and should be reviewed carefully.

Crisis-Related Fund Expenses

As with other expense allocation decisions, prior to allocating crisis-related expenses between funds or between a fund and an adviser, carefully consider the language in the operative fund documents.

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Record-Keeping

After major market events in the past, the SEC has conducted sweep examinations seeking to understand how investment advisers respond to financial and operational challenges. Each adviser should maintain appropriate contemporaneous records that document how it assessed and responded to the financial and operational challenges posed by the current crisis for business continuity and to assist with responding to potential regulatory scrutiny.

1. Public Statement, "Statement from Stephanie Avakian and Steven Peikin, Co-Directors of the SEC's Division of Enforcement, Regarding Market Integrity" (March 23, 2020), available at, <https://www.sec.gov/news/public-statement/statement-enforcement-co-directors-market-integrity>
2. Force Majeure Clauses: A 4-Step Checklist & Flowchart, Gibson, Dunn & Crutcher LLP (March 24, 2020) <https://www.gibsondunn.com/wp-content/uploads/2020/03/force-majeure-clauses-a-4-step-checklist-and-flowchart.pdf>.
3. Coronavirus and Force Majeure: Addressing Epidemics in LNG and Other Commodities Contracts, Dunn & Crutcher LLP (February 14, 2020), available at, <https://www.gibsondunn.com/coronavirus-and-force-majeure-addressing-epidemics-in-lng-and-other-commodities-contracts/>.
4. 17 CFR § Part 243 - Regulation FD, available at, <https://www.govinfo.gov/content/pkg/CFR-2012-title17-vol3/pdf/CFR-2012-title17-vol3-part243.pdf>.
5. 17 CFR § 240.10b5-1 Trading "on the basis of" material nonpublic information in insider trading cases, available at, <https://www.govinfo.gov/content/pkg/CFR-2013-title17-vol3/pdf/CFR-2013-title17-vol3-sec240-10b-3.pdf>.
6. Press Release, U.S. Securities and Exchange Commission, Division of Investment Management, "SEC Takes Targeted Action to Assist Funds and Advisers, Permits Virtual Board Meetings and Provides Conditional Relief from Certain Filing Procedures" (March 13, 2020), available at, <https://www.sec.gov/news/press-release/2020-63>; Press Release, U.S. Securities and Exchange Commission, Division of Investment Management, "SEC Extends Conditional Exemptions From Reporting and Proxy Delivery Requirements for Public Companies, Funds, and Investment Advisers Affected By Coronavirus Disease 2019 (COVID-19)" (March 25, 2020), available at, <https://www.sec.gov/news/press-release/2020-73>.
7. 17 CFR § 275.206(4)-2 - Custody of funds or securities of clients by investment advisers, available at, <https://www.govinfo.gov/content/pkg/CFR-2011-title17-vol3/pdf/CFR-2011-title17-vol3-sec275-2064-2.pdf>.
8. Staff Responses to Questions About the Custody Rule, U.S. Securities and Exchange Commission, Division of Investment Management (March 2010), available at, https://www.sec.gov/divisions/investment/custody_faq_030510.htm.
9. See Accounting Standards Update No. 2011-04 (May 2011), available at, <https://asc.fasb.org/imageRoot/00/7534500.pdf>.

Gibson Dunn's lawyers are available to assist with any questions you may have regarding developments related to the COVID-19 outbreak. For additional information, please contact any member of the firm's [Coronavirus \(COVID-19\) Response Team](#).

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Gibson Dunn lawyers regularly counsel clients on issues raised by this pandemic, and we are working with many of our clients on their response to COVID-19. Please feel free to contact the Gibson Dunn lawyer with whom you usually work, any member of the firm's [Securities Enforcement Group](#), or the authors:

Mark K. Schonfeld - New York (+1 212-351-2433, mschonfeld@gibsondunn.com)
Reed Brodsky - New York (+1 212-351-5334, rbrodsky@gibsondunn.com)
Barry R. Goldsmith - New York (+1 212-351-2440, bgoldsmith@gibsondunn.com)
Gregory Merz - Washington, D.C. (+1 202-887-3637, gmerz@gibsondunn.com)
C. William Thomas, Jr. - Washington, D.C. (+1 202-887-3735, wthomas@gibsondunn.com)
)
Mary Beth Maloney – New York (+1 212-351-2315, mmaloney@gibsondunn.com)
Ronald O. Mueller - Washington, D.C. (+1 202-955-8671, rmueller@gibsondunn.com)
Tina Samanta (+1 212-351-2469, tsamanta@gibsondunn.com)
Chris Hamilton - New York (+1 212-351-2495, chamilton@gibsondunn.com)
Nicholas C. Duvall - Washington, D.C. (+1 202-887-3781, nduvall@gibsondunn.com)

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