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SEC's Life Sciences Actions Utilize Novel Tools And Theories

By **Edward Imperatore and Jina Choi** (October 16, 2023, 6:35 PM EDT)

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The U.S. Securities and Exchange Commission and U.S. Department of Justice have touted a renewed focus on traditional forms of securities fraud, including insider trading, accounting fraud and disclosure fraud involving public companies.

Government scrutiny and enforcement efforts have increasingly mounted against the life sciences and health care industry. Recent months have seen a wave of enforcement actions against publicly traded life sciences and health care companies and their executives involving allegations of insider trading or accounting fraud.

These actions underscore the need for public companies to implement internal controls for both accounting and trading activity to mitigate risk.

Why Life Sciences and Health Care

When early-stage public companies, including those in the life sciences and health care industry, experience rapid growth that outpaces the development of internal controls, regulatory scrutiny frequently results.

The government scrutinizes, among other things, accounting practices and trading activity involving companies that rely heavily on and tout earnings growth or are the subject of mergers and acquisitions, which are common characteristics of early-stage life sciences companies.

The SEC, moreover, has implemented new forms of data analytics designed to detect what it views as earnings management and unusual patterns in securities trading activity.

- The SEC touts a data-driven earnings-per-share, or EPS, initiative to investigate and scrutinize what it views as earnings management practices by public companies, including companies that repeatedly, seemingly systematically, reach earnings and revenue targets.

- The SEC also lauds its data-driven initiative to identify suspicious trading activity, including trading around earnings releases and announcements of product developments or mergers and acquisitions. The SEC continues to use data to discern patterns in voluminous trading data, including trading activity that spans months or years.

As discussed further below, the SEC's use of data analytics has resulted in securities investigations and enforcement actions against life sciences and health care companies and their executives.

Because the DOJ criminal securities fraud investigations typically begin with a referral from the SEC, the SEC's use of data analytics has resulted also in DOJ scrutiny and parallel DOJ criminal cases.

Insider Trading Theories

The government has recently applied the insider trading laws in noteworthy and novel ways in the context of life sciences companies, highlighting important compliance and corporate governance considerations.

Rule 10b5-1 Plans

The DOJ and SEC have recently charged executives with insider trading based on trades placed pursuant to Rule 10b5-1 trading plans.

For example, in U.S. v. Peizer in the U.S. District Court for the Central District of California in March, the government **charged** Terren Peizer, an executive of a health care company, with insider trading for selling shares of his company pursuant to Rule 10b5-1 trading plans while he was allegedly in possession of material nonpublic information, or MNPI, and thus allegedly avoided millions of dollars in losses.

Peizer is the first DOJ insider trading prosecution based solely on trades placed pursuant to a Rule 10b5-1 plan, and DOJ officials have announced that additional criminal cases involving Rule 10b5-1 plans are likely to follow.

According to the SEC and DOJ, the charges in Peizer resulted from a data-driven initiative to identify alleged abuses of Rule 10b5-1 plans. While the case comes on the heels of recent SEC amendments to Rule 10b5-1, the new amendments did not affect the charges brought against Peizer.

Takeaways

The Peizer case, which is part of the government's crackdown on Rule 10b5-1 plans, underscores that Rule 10b5-1 provides no defense if an executive is in possession of MNPI when he or she establishes the Rule 10b5-1 plan.

To establish criminal intent in Peizer, the DOJ relied on traditional evidence of consciousness of guilt, including evidence that the defendant allegedly disregarded advice to observe a cooling-off period before trading and alleged false statements in Rule 10b5-1 plan certifications.

Companies should update their guidance and training of executives and employees regarding Rule 10b5-1 plans and address SEC amendments, including the requirement that directors and officers certify that they are not in possession of MNPI at the time the plan is adopted and that the plan is entered in good faith.

In addition, Rule 10b5-1 plans can be particularly useful at life sciences companies, where share price is often driven by significant events, such as scientific developments and regulatory approvals.

Hybrid or Remote Work

The DOJ and SEC have recently brought insider trading actions involving allegations of misappropriation of confidential business information of life sciences or tech companies that was accessible to employees working from home.

For example, in U.S. v. Markin in the U.S. District Court for the Southern District of New York last year, the DOJ and SEC **charged** Seth Markin, the ex-boyfriend of a law firm associate, for allegedly misappropriating MNPI from his girlfriend, who was working from home on a planned tender offer of a large pharmaceutical company, Merck & Co. Inc., during the COVID-19 pandemic.

The indictment alleged that the boyfriend overheard his girlfriend's work calls and reviewed hard-copy documents containing MNPI. It further alleged that the girlfriend confided in him about her law firm's work on the tender offer.

Similarly, in U.S. v. Meadow in the Southern District of New York in June, the government **alleged** that Jordan Meadow searched the work laptop of his girlfriend, an executive assistant at a global investment bank, Morgan Stanley, and reviewed Outlook emails containing summaries of M&A activity, including acquisitions of tech companies, for valuation and fairness committee meetings.

The boyfriend allegedly installed software on his girlfriend's work laptop to keep the computer unlocked during periods of inactivity, and he accessed the laptop when his girlfriend was not present. The boyfriend allegedly tipped his friends, who used MNPI to trade profitably in advance of announced tech company acquisitions.

In both Markin and Meadow, the government alleged that the boyfriend breached a relationship of trust and confidence — a required element of the misappropriation theory of insider trading — owed to his girlfriend, who possessed MNPI as an insider. The government used this theory to reach an outsider who did not owe a duty of trust and confidence to the company but understood that his girlfriend owed a duty and possessed MNPI.

Takeaways

These DOJ and SEC charges show the government's focus on enforcing the securities laws in remote or hybrid workplaces.

The cases demonstrate the compliance risks inherent in work-from-home environments, including challenges in safeguarding information discussed by phone or shown on a computer screen.

From the standpoint of corporate governance, it is important for public companies and firms in possession of MNPI to train employees on safeguarding MNPI at home, require compliance certifications, and implement protocols and safeguards for accessing MNPI from outside the office while balancing employees' legitimate need for access.

Shadow Insider Trading

In 2022, the U.S. District Court for the Northern District of California denied a motion to dismiss a novel insider trading enforcement action brought by the SEC based upon a theory that commentators have called shadow insider trading.

In SEC v. Panuwat, which involved a corporate acquisition involving life sciences companies, the SEC took the position that the insider trading laws apply where an insider uses material nonpublic information about his or her own company to trade securities of another company, such as a competitor or peer company in the same industry.

In Panuwat, the SEC brought an enforcement action against a former senior business development executive at Medivation Inc., a publicly traded biopharmaceutical company, for insider trading.

The SEC alleged that the executive, Matthew Panuwat, committed insider trading based upon his confidential knowledge that Medivation would soon be acquired.

The executive, however, did not trade the securities of his own company, Medivation. Instead, the executive allegedly used the confidential information he learned about the acquisition to trade in the securities of Incyte Corp., a different biopharmaceutical company that was not involved in the acquisition.

This trade allegedly violated Medivation's insider trading policy, which prohibited using confidential Medivation information to trade securities of any other company using MNPI learned from Medivation.

The SEC took the position that confidential information about the acquisition of Medivation was material to Incyte because Medivation and Incyte were closely comparable mid-cap companies in an industry sector that was the subject of potential mergers and acquisitions.

Takeaways

Although the facts of Panuwat are unusual, the case highlights important corporate governance considerations.

First, a company should review its insider trading policy and modify it as appropriate in consideration of new regulations, case law, and corporate governance trends.

Second, vague or overbroad language in an insider trading policy could broaden the scope of potential liability for employees or insiders who are subject to the policy.

Third, effective corporate training on insider trading liability is crucial to ensure that employees and other insiders are aware of the full scope of a company's insider trading policy.

Fourth, companies should establish procedures to monitor potential violations and enforce the full scope of the policy.

Accounting and Disclosure Fraud Theories

At publicly traded life sciences and health care companies, the government has focused on both (1) alleged inflations of earnings and earnings management, and (2) alleged misstatements to accountants and auditors.

Earnings Management and Inflation of Earnings Metrics

Based in part on its EPS initiative, the SEC has brought a wave of earnings management actions, including in the life sciences industry.[1]

These actions show the government appears to be focused not on dramatic increases in revenue or earnings, but rather on instances in which a company reaches its revenue or EPS guidance or consensus estimates by slim margins, quarter after quarter, including by making discretionary, post-closing accounting adjustments.

The government likewise continues to focus on traditional allegations of improper revenue recognition. For example, the SEC charged American Renal Associates Holdings Inc., a national provider of dialysis services, and three of its former executives for participating in an alleged scheme to make unsupported topside adjustments to the company's revenue to account for anticipated Medicare payments.

According to the SEC, the executives allegedly took steps to "cookie jar," or store and distribute, revenue to make it appear that the company was consistently reaching its targets. The investigation and charges, which survived a defense motion to dismiss, followed the company's restating several years of financial reporting.

The SEC's focus on allegations of earnings management and revenue recognition fraud, in turn, has led to increased DOJ scrutiny and criminal prosecutions of executives.

Misleading Accountants and Auditors

A little-known statute passed as part of the Sarbanes-Oxley Act of 2002 criminalizes "improper influence on the conduct of audits," or making materially false statements or omissions to internal accountants or outside auditors conducting an annual audit or quarterly review.[2]

This statue is attractive to prosecutors because it allows the government to construct an accounting fraud case without alleging a misstatement to the market or inflation of an earnings metric.

In its investigations, the government has scrutinized the flow of information between senior management and both internal accountants and outside auditors, including management representation letters, Sarbanes-Oxley certifications attached to SEC filings, and communications relating to sales and transaction terms.[3]

Conclusion

Recent enforcement actions show the government's focus on enforcing the securities laws against insider trading and accounting fraud in the life sciences and health care industry.

These actions underscore that companies must implement effective internal controls to mitigate risk. In addition, when companies evaluate potential mergers or acquisitions, due diligence should seek to ensure that the target company implements robust policies and procedures.

Securities Trading

A company's insider trading policy should be tailored to reflect the latest enforcement developments, and employees and other insiders should be trained on the full scope of the policy and certify their compliance.

The policy should bind third parties serving the company, including contractors, consultants and other agents. When potential violations are detected, the company should enforce the policy and document its remedial measures.

Accounting

Companies should devise and implement procedures for making discretionary accounting adjustments and document how those adjustments are made.

In addition, procedures should ensure a complete and well-documented flow of information from management to internal accountants and outside auditors, particularly to disclose and account for material sales and other transactions reflected in the company's revenue and earnings.

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[1] See, e.g., In re Healthcare Servs. Grp. Inc., No. 3-20468 (SEC Aug. 24, 2021).

[2] 15 U.S.C. § 7202, 7242 & 78ff; 17 C.F.R. §240.13b2-2.

[3] See, e.g., United States v. Petit, 19 Cr. 850 (JSR) (S.D.N.Y.).