

SEC Is Pushing Boundaries In Insider Trading Enforcement

By **Mark Cahn, Elizabeth Mitchell and Brett Atanasio** (February 7, 2022)

The U.S. Securities and Exchange Commission's actions in 2021 demonstrated that insider trading remains a key enforcement priority.

While the absolute number of insider trading enforcement actions brought by the SEC has declined in recent years,[1] the actions brought last year demonstrate the SEC's interest in pursuing new categories of actors and novel theories that push the boundaries of insider trading jurisprudence.

First, in July 2021 in the U.S. District Court for the Southern District of New York, in *SEC v. Trovias*, the SEC brought its first insider trading case involving the dark web, where anonymized internet activity has long been suspected to be a breeding ground for unlawful trading.

In August 2021, the SEC brought a rare enforcement action involving shadow trading, *SEC v. Panuwat*, in the U.S. District Court for the Northern District of California, which involves trading in the securities of a company about which the person has no direct material nonpublic information while in possession of MNPI about a similarly situated company

The SEC also brought its first securities fraud case against an alternative data provider in September 2021, *In the Matter of App Annie Inc.*, which, while not an insider trading matter, may serve as a warning sign of insider trading actions to come.

Moreover, in September 2021, the commission brought *SEC v. Cavco Industries Inc.* in the U.S. District Court for the District of Arizona — its second case that uses the Securities Exchange Act Section 13(b)(2)(B), the requirement that public companies maintain internal accounting controls as a tool to police alleged corporate insider trading activity.

These boundary-pushing cases are not without challenge. Two of the four cases mentioned above are in litigation, and the SEC is currently litigating other insider trading-related matters as well.

Notably, *SEC v. Clark*, predicated in large part on a pattern of trading following contact with a relative who was an insider, was dismissed late last year before the defendant even had to present any evidence.[2] It remains to be seen whether this and other instances of judicial scrutiny will cause the SEC to reevaluate its approach.

SEC Shines a Light on the Dark Web and Shadow Trading

The dark web is a portion of the internet that contains hidden websites that cannot be accessed through traditional web browsers. It allows users to purchase and sell products — oftentimes, illegal products — under the cover of anonymity. While the dark web has long been suspected to be a tool for unlawful insider trading,[3] it had not been a subject of SEC enforcement action until this year.



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In July, the SEC brought insider trading and other fraud charges in the Southern District of New York against Apostolos Trovias, a participant on the dark web who operated under the pseudonym "TheBull" and sold insider trading tips to investors.[4] Over the course of several years, Trovias is alleged to have sold such tips through over 100 weekly and monthly subscriptions, as well as through one-off sales.[5]

According to the SEC's complaint, either Trovias wrongfully obtained and traded on or sold genuine MNPI — in which case he engaged in garden-variety insider trading and tipping — or he made up the alleged MNPI in order to trick his subscribers into believing he was selling inside information — in which case he did not engage in insider trading but did engage in garden-variety securities fraud.[6]

In August, the commission brought a rare case in the U.S. District Court for the Northern District of California predicated on what has been dubbed the shadow trading method of insider trading. Shadow trading can occur when a person trades in the securities of Company A while in possession of MNPI about Company B, and Companies A and B are similarly situated.

In SEC v. Panuwat, the SEC charged Matthew Panuwat with insider trading in advance of the public announcement that his employer, Medivation, a midsize oncology-focused biopharmaceutical company, would be acquired by pharmaceutical giant Pfizer Inc.[7] Notably, Panuwat did not trade in the securities of Medivation or Pfizer; instead, he is alleged to have bought options in Incyte Corp., another midsize oncology-focused biopharmaceutical company, minutes after Medivation's CEO internally relayed positive news about the potential Pfizer acquisition.[8]

On the day that the Medivation-Pfizer deal was publicly announced, Incyte's share price went up 8%.[9] At the time, Medivation's insider trading policy prohibited employees possessing MNPI about Medivation from trading in securities of Medivation or of other publicly traded companies based on that information.[10]

The following facts were among those cited by the SEC in support of its theory: that Panuwat, an expert in the biopharmaceutical industry and a former investment banker himself,

- Worked closely with investment bankers advising Medivation;
- Reviewed presentations authored by those investment bankers that discussed Medivation's peer companies and drew close parallels between Medivation and Incyte;
- Had himself noted to the investment bankers that they may want to consider Incyte a company comparable to Medivation; and
- Knew that, to the extent a large-cap pharmaceutical company was interested in acquiring a mid-cap oncology-focused biopharmaceutical company, there were only a

few left to acquire and the acquisition of one made the others potentially more valuable acquisition targets.[11]

Relatedly, the complaint alleges that Panuwat knew the stock prices of both Medivation and Incyte had risen following the 2015 announcement that a third then-peer firm would be acquired by a large pharmaceutical company.[12]

Panuwat filed a motion to dismiss, arguing both that the SEC had not adequately pled its case and that the novel application of the misappropriation theory would improperly expand insider trading law and thereby violate his due process rights. In mid-January 2022, the Northern District of California district court denied Panuwat's motion, holding that "although unique, the SEC's theory of liability falls within the contours of the misappropriation theory and the language of the applicable law." [13]

In particular, the court highlighted that the securities laws broadly "prohibit insider trading of 'any security' using 'any manipulative or deceptive device'" and do not require that the MNPI about a security or issuer "come from the security or issuer itself in order to be material." [14]

Given that conclusion, the court held that the SEC adequately pled that the information relating to the Pfizer-Medivation deal was material to Incyte.[15] The court further held that the SEC had sufficiently pled Panuwat breached a duty by violating Medivation's insider trading policy and that Panuwat acted with scienter based on the timing of Panuwat's trading.[16]

It remains to be seen how aggressively the SEC will push shadow trading theories in future cases.

Pursuing Insider Trading Through Internal Controls

The SEC is continuing to leverage Section 13(b)(2)(B) of the Exchange Act — which requires public companies to devise and maintain internal accounting controls — in the insider trading context, this time in a litigated matter filed in September 2021 against Cavco Industries Inc., in the District of Arizona.

This theory, which the SEC first employed in a settled SEC administrative proceeding against Andeavor Corp. in late 2020, is not without controversy. Notably, Commissioners Hester Peirce and Elad Roisman had voted against the Andeavor settlement and objected publicly.

At the time, they emphasized that Section 13(b)(2)(B) imposes not a general requirement of internal controls but a specific requirement to devise and maintain appropriate internal accounting controls,[17] and questioned whether "it is our role under Section 13(b)(2)(B) to second-guess management's decision processes on matters that do not directly implicate the accuracy of a company's accounting and financial statements." [18]

That question is now teed up in the litigated Cavco matter. The complaint alleges that Cavco violated Section 13(b)(2)(B) by failing to devise and maintain a system of internal accounting controls sufficient to provide reasonable assurance that its securities trading would be executed in accordance with its board's authorization, its corporate investment policy, and its securities trading policy.[19]

Although Cavco had an investment policy that imposed certain requirements on corporate investments and an insider trading policy that prohibited employees from purchasing securities while in the possession of MNPI, the SEC alleges that Cavco's CEO caused the company to purchase the shares of four companies with which it was in ongoing direct merger or joint venture negotiations.[20]

This was possible, the SEC alleges, because Cavco did not have processes or controls in place to ensure that the investment policy and insider trading policy were being followed.[21] Such gaps, the SEC argues, showed that Cavco lacked accounting controls "sufficient to provide reasonable assurances that transactions were executed in accordance with management's general or specific authorization." [22]

As the case proceeds through litigation, the courts may very well provide needed clarity on the scope of Section 13(b)(2)(B)'s application to securities trading by public companies.

The First Enforcement Action Against an Alternative Data Provider

In September 2021, the SEC brought an administrative proceeding against app data provider App Annie and its founder for securities fraud. While this action — the first against an alternative data provider — is not premised on an allegation of insider trading, it suggests that the commission could pursue insider trading investigations based on similar fact patterns and analogous theories of liability.

Alternative data refers to data about a company that is not in its financial statements, or as the SEC describes it, "data gleaned from nontraditional sources." [23] App Annie collects and analyzes app usage and provides information to trading firms. In recent years, the SEC's Division of Examinations has repeatedly noted its interest in the use of alternative data by market actors, noting in particular questions about whether firms have appropriate compliance policies, procedures and controls governing use of such data.[24]

App Annie represented to the companies that provided data that their data would be aggregated and anonymized before it was provided to trading firms.[25] Despite this, the SEC alleged that App Annie incorporated nonanonymized and nonaggregated data into its models in order to make its analyses more valuable to trading firms.[26]

Additionally, according to the SEC, App Annie misrepresented to its trading firm customers that its analyses were generated in a manner consistent with its terms of service.[27] The SEC charged that because App Annie lied to its data sources about how their data would be used and lied to the trading firms about the content of the data provided, App Annie engaged in securities fraud.[28]

Of note, the decision was not unanimous — Peirce tweeted that the settlement "stretches the 'in connection with the purchase or sale of securities' requirement ... beyond where I think it should go." [29]

The App Annie case raises important considerations for any market participant that receives data analyses from third-party aggregators. In App Annie, the SEC identified the trading firms as victims of App Annie's alleged fraud.

But in the future, the SEC may be inclined to bring enforcement actions against trading firms based on different facts: Should the trading firms have spotted red flags about the data or the conduct of the data aggregator? Did the trading firms know, or should they have known whether the data was obtained, collected or provided improperly?

This matter highlights the need for consumers of such information to develop and maintain robust procedures to review the quality of their counterparties and the data they provide.

In summary, the SEC's 2021 enforcement actions demonstrate its continued commitment to policing insider trading. While many of its enforcement actions were consistent with more traditional types of insider trading, the cases described above also indicate that the SEC is willing to pursue different and even novel theories of liability to pursue what it perceives as wrongful conduct.

Whether boundary-pushing actions indicate an expanded set of enforcement priorities or will remain outliers remains to be seen.

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[1] In Fiscal Year 2018, the SEC brought 51 insider trading enforcement actions; however, those actions dropped to 32, 33, and 28, in Fiscal Years 2019, 2020, and 2021, respectively. See SEC, Div. of Enforcement, Annual Report 20 (2018), <https://www.sec.gov/files/enforcement-annual-report-2018.pdf>; SEC, Div. of Enforcement, Annual Report 29 (2019), <https://www.sec.gov/files/enforcement-annual-report-2019.pdf>; SEC, Div. of Enforcement, Annual Report 29 (2020), <https://www.sec.gov/files/enforcement-annual-report-2020.pdf>; Press Release, SEC, SEC Announces Enforcement Results for FY 2021, Addendum (Nov. 17, 2021), <https://www.sec.gov/news/press-release/2021-238>.

[2] See Order, Sec. & Exch. Comm'n v. Clark, No. 21-cv-06322 (E.D. Va. Dec. 13, 2021); see also Dean Seal, SEC's Stunning Trial Loss Rattles Its Insider Trading Strategy, Law360 (Dec. 16, 2021), <https://www.law360.com/articles/1449115/sec-s-stunning-trial-loss-rattles-its-insider-trading-strategy>.

[3] See Jesse Atlas, Insider Trading on the Dark Web, Forbes (Mar. 25, 2014), <https://www.forbes.com/sites/realspin/2014/03/25/insider-trading-on-the-dark-web/>.

[4] See Complaint at 1, Sec. & Exch. Comm'n v. Trovias, No. 21-cv-05925 (S.D.N.Y. July 9, 2021). According to the Complaint, Trovias' customers purchased securities based on his "tips"—sometimes confirming in writing that they had engaged in profitable trades based on his information. See *id.* at 9.

[5] *Id.* at 2, 6–7.

[6] Id. at 7. In March, the SEC and Department of Justice brought similar fraud charges against James Roland Jones based on his scheme to sell fake "insider tips" on the dark web. See Press Release, SEC, SEC Charges California-Based Fraudster With Selling "Insider Tips" on the Dark Web (Mar. 18, 2021), <https://www.sec.gov/news/press-release/2021-51>.

[7] Complaint at 1–2, Sec. & Exch. Comm'n v. Panuwat, No. 21-cv-06322 (N.D. Cal. Aug. 17, 2021).

[8] Id. at 5–9.

[9] Id. at 9.

[10] Id. at 5.

[11] Id. at 5–7.

[12] Id. at 6.

[13] Order at 13, Sec. & Exch. Comm'n v. Panuwat, No. 21-cv-06322 (N.D. Cal. Jan. 14, 2022).

[14] Id. at 7.

[15] Id.

[16] Id. at 8–11.

[17] See Hester Peirce & Elad Roisman, Statement of Commissioners Hester M. Peirce and Elad L. Roisman – Andeavor LLC (Nov. 13, 2020), https://www.sec.gov/news/public-statement/peirce-roisman-andeavor-2020-11-13#_ftn1.

[18] See id.

[19] Complaint at 1–4, Sec. & Exch. Comm'n v. Cavco Indus., Inc., No. 21-cv-01507 (D. Ariz. Sept. 2, 2021).

[20] Id. at 5–6, 9–10, 14, 17–18.

[21] Id. at 22–23.

[22] Id.

[23] SEC, Div. of Examinations, 2021 Examination Priorities 26 (2021), <https://www.sec.gov/files/2021-exam-priorities.pdf>.

[24] See id.; see also SEC, Off. of Compliance Inspections & Examinations, 2020 Examination Priorities 14 (2020), <https://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2020.pdf>.

[25] Order Instituting Cease-and-Desist Proceedings ¶ 2, App Annie Inc., Exchange Act Release No. 92975 (Sept. 14, 2021).

[26] Id. ¶¶ 3, 29–30, 45–47.

[27] Id. ¶¶ 18–21.

[28] Id. ¶¶ 2–5.

[29] @HesterPeirce, Twitter (Sept. 14, 2021, 3:34 PM).