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Aggressive Insider Trading Enforcement Will Persist This Year

By **Daniel Fetterman, Brian Choi and Joshua Roberts**
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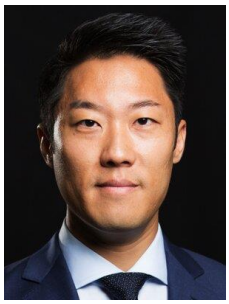
Companies and individuals can expect to see a continuing trend of aggressive insider trading enforcement this year.

Daniel Fetterman

Last year, the U.S. Securities and Exchange Commission brought 43 insider trading cases — up from 28 in 2021 and 33 in 2020 — often as parallel proceedings with the U.S. Department of Justice.[1]

While these cases span a wide variety of industries, with many predicated on the classical, or tipper-tippee, theory, some notable cases have arisen in new contexts.

With the government now having waded into prosecuting schemes involving cryptocurrency and nonfungible tokens, it faces a new challenge of successfully demonstrating that these digital assets constitute securities that fall within the purview of Section 10(b) of the Securities Exchange Act and Rule 10b-5 thereunder.

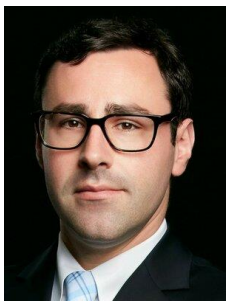


Brian Choi

The following is what we anticipate seeing in what promises to be an active and innovative 2023 for the enforcement agencies.

Insider Trading Enforcement Focus on Digital Assets

As blockchain technology and cryptocurrency become increasingly prevalent in today's marketplace, the regulatory scrutiny on these digital assets will only intensify. In the past year, both the DOJ and the SEC brought first-of-their-kind cases in this space.



Joshua Roberts

The cases have triggered a vigorous debate around the question of whether digital assets such as NFTs or cryptocurrency are securities. The SEC's ability to regulate fraudulent conduct concerning those assets depends on the answer to that question.

Securities or not, the DOJ has used its broader arsenal, relying principally on the robust and reliable wire fraud statute, to prosecute these insider trading-type cases.

Last summer, the DOJ and SEC brought parallel actions charging a former product manager of a

prominent cryptocurrency exchange, Coinbase Global Inc., and others for trading on confidential information about crypto assets — i.e., tokens — that were scheduled to be listed on Coinbase's exchange.[2]

The defendants knew that a token's market value would increase significantly following an announcement that the token was going to be listed on the exchange.

The DOJ articulated a straightforward wire fraud and conspiracy theory, alleging that the defendants conspired and engaged in a scheme to defraud by misappropriating Coinbase's confidential information — and tipped others about it — to purchase certain tokens in advance of Coinbase's public listing announcements.

The DOJ secured guilty pleas from two of the defendants in U.S. v. Wahi, and in January 2023, one of them was sentenced to 10 months in prison by the U.S. District Court for the Southern District of New York.[3]

In its parallel case, the SEC designated nine out of the 25 digital tokens as securities and alleged that defendants' fraud implicated Section 10(b) Rule 10b-5.[4]

If the SEC is successful in establishing that these assets are securities, it will trigger a host of consequences that extend well past the immediate case.

Crypto assets will be subject to the same regulatory framework governing securities — e.g., requiring registration — and expose the companies behind the digital tokens to the same enforcement risks for noncompliance.[5]

Whether the SEC succeeds or not, its message is clear: The government has the appetite and resources for aggressive enforcement in the still-novel and rapidly developing market for digital assets.

The fallout from the collapse of FTX — once the darling of the crypto world — has served only to embolden regulators to be vigilant in its crypto oversight and enforcement.

Last summer, the DOJ also brought its first-ever NFT fraud case, U.S. v. Chastain, charging a former product manager at OpenSea, the largest online NFT marketplace, with insider trading.[6]

According to the DOJ, the defendant secretly purchased certain NFTs that he knew OpenSea planned to feature on its website. After OpenSea announced the NFTs that it would showcase, the value of those NFTs surged, allowing the defendant to pocket profits of two- to five-times his initial purchase price.

As with the Coinbase case, the DOJ charged the defendant with wire fraud, in addition to money laundering — an indication that it did not view NFTs as securities.

The charges against the defendant remain pending in the Southern District of New York,[7] and we expect to see more NFT-related cases as the market for these assets continues to grow.

Shadow Trading Theory of Liability

While we expect that the SEC will bring its fair share of traditional insider trading cases this year, if last year is any indication of what's to come, it also will continue to test the limits of insider trading liability.

Shadow trading, for example, has — at least for now — emerged as a viable theory. Unlike the classical theory, shadow trading applies to the use of material nonpublic information in one company in connection with trading in the stock of a similarly situated competitor company.

The shadow trading theory rests on the proposition that events affecting one company may predictably affect the stock price of other companies in the same market or industry.

In SEC v. Panuwat, for example, a pharmaceutical executive was charged with using confidential information about the impending acquisition of his employer to purchase call options in an unrelated competitor's stock.

When his employer's acquisition was announced, as the defendant expected, the stock price of the unrelated competitor company also surged, allowing him to reap a profit of more than $100,000.[8]

Finding this theory "grounded in precedent ... [and] commonsense," the U.S. District Court for the Northern District of California allowed the SEC's claim to survive a motion to dismiss last January.[9] With discovery underway, however, it remains unclear whether the SEC can prevail on the merits.

The shadow trading theory is remarkable because it seeks to punish any party who trades on a company to which it does not owe a duty of trust and whose confidential information was not used as the basis of the trade. It signals the SEC's view that information about one company is material enough to affect the stock prices of its peers.

A victory in this case for the SEC will undoubtedly broaden the regulatory dragnet and increase scrutiny on the possession and use of collateral confidential information in making trades.

Rule 10b5-1 Revisions and Enforcement

In December 2022, the SEC amended Rule 10b5-1, a safe harbor that allows insiders to prearrange the purchase and sale of their company's stock pursuant to a trading plan.

Since the rule's initial adoption in 2000, commentators have expressed concerns that corporate officers have gamed the system by adopting and terminating trading plans opportunistically based on inside information.[10]

For example, an insider with knowledge of information that may increase a company's stock price could elect to hold onto his shares — despite a prearranged sale under his Rule 10b5-1 plan — by unilaterally terminating the plan. Or, executives with material confidential information may deliberately time their trades to occur shortly after adopting a plan.

The amendments are designed to curb such manipulative conduct.

In relevant part, the amendments — which are expected to go into effect on Feb. 27 — generally provide the following.

Good Faith Requirement

An executive must adopt a trading plan in good faith and continue to act in good faith even after the plan's adoption.

Cooling-Off Period

There is now a cooling-off period following the adoption or modification of a trading plan.

An insider is prohibited from trading until the later of (1) 90 days following plan adoption or modification; or (2) two business days following the disclosure of the company's financial results, i.e., Form 10-K or 10-Q, for the fiscal quarter in which the plan was adopted or modified, with the maximum cooling-off period capped at 120 days following the adoption of a plan.

For nonofficers and nondirectors, a shorter 30-day cooling-off period applies.

This requirement is intended to guard against opportunistic trading by increasing the time between the receipt of nonpublic material information and the adoption of a plan.

Knowledge Certifications

Directors and officers are now required to make certifications that they were not aware of any material nonpublic information about the company or its securities.

Prohibition Against Multiple Plans

The amendments bar insiders from adopting multiple, overlapping plans at the same time, subject to limited exceptions. Individual insiders may rely on a single trading plan during any 12-month period — the 10b5-1 defense is only available if the insider has not, in the preceding 12-month period, adopted another plan that qualified for 10b5-1 protections.

These requirements are intended to mitigate the risk that insiders will use overlapping plans, or selectively modify or terminate their plans, to manipulate trades on the basis of material nonpublic information.

These amendments come on the heels of reports that regulators have been investigating executives for trading on inside information under cover of their Rule 10b5-1 plans.

These investigations will likely remain active and may potentially result in enforcement actions later this year, especially since the amendments will not affect trading plans that were in place prior to the effective date of the amendments.

For example, Sientra Inc., a breast implant company, disclosed in the third quarter of 2022 that it had received subpoenas from the SEC and the DOJ for information relating to its former CEO's trading activities.[11]

And, in September 2022, the SEC brought an enforcement action against the CEO and former president of Cheetah Mobile for establishing a Rule 10b5-1 trading plan after becoming aware of a significant drop-off in the company's advertising revenues.[12] By adopting plans to sell their shares with this information, the executives avoided hundreds of thousands of dollars in losses.

Congressional Insider Trading

The past several years have seen a renewed interest in bolstering the Stop Trading on Congressional Knowledge, or STOCK, Act, a statute that prohibits members of U.S. Congress, their employees and other government officials from utilizing nonpublic information derived from their official responsibilities to make a profit.[13]

Those activities include trading on stocks that — based on the disclosure of several lawmakers — includes cryptocurrency transactions.[14]

The effort to strengthen the STOCK Act was largely driven by reports that several U.S. senators had sold their stocks and avoided substantial losses based on their advanced knowledge about the onset of the coronavirus pandemic.[15]

In 2022, Congress introduced legislation to prohibit lawmakers from trading stocks while in office and to require them to either to divest their stock positions or place them into a blind trust.[16]

While none of these bills have survived, the media has continued to spotlight the dangerous conflicts of interests that lawmakers face between performing their public duties — e.g., investigating companies — and conducing their private affairs, e.g., overseeing their personal financial investments.[17]

Indeed, The New York Times discovered that, over a three-year period, 97 members of Congress reported trading on stocks — either by themselves or their immediate family members — of companies over which they had oversight.[18]

Although there is broad public support to ban members of Congress from trading stocks,[19] research by the National Bureau of Economic Research revealed that since the STOCK Act, senators' stock trading behavior and returns do not outperform stocks in the same industry and size, even when those industries related to committee assignments.[20]

However, members of Congress are in a unique position of possessing enough knowledge that, in many cases, falls short of the legal definition of insider information, but is sufficient to create significant ethical and moral predicaments.

Even as the proposed amendments to the STOCK Act lose steam, lawmakers are not immune to insider trading prosecutions.

The SEC and DOJ, for example, investigated a number of senators — privy to advanced briefings about the threat of COVID-19 — who avoided substantial losses as a result of selling stocks just a week before the onset of the pandemic sent the equities market plunging.

While recent reports indicate that the lawmakers **would not** be charged,[21] the government likely will continue to prioritize these issues to try to preserve the public's trust.

Conclusion

We expect regulatory scrutiny of insider trading to continue to grow this year, particularly in cryptocurrency and digital assets where the risk of abuse is acute, the regulatory framework is in flux and the public's level of concern is high.

The SEC, in particular, will face some major challenges, including its attempt to prevail on the novel shadow trading theory of liability, and to demonstrate, on a much larger scale, that the cryptocurrency assets it seeks to regulate are, in fact, securities subject to its enforcement authority.

The latter issue will not only affect the SEC's ability to regulate by enforcement, but could fundamentally expand its role in the crypto world.

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[1] Addendum to Division of Enforcement Press Release, Fiscal Year 2022, available at https://www.sec.gov/files/fy22-enforcement-statistics.pdf.

[2] Indictment, United States v. Wahi, No. 1:22-cr-00392 (S.D.N.Y. July 19, 2022), ECF No. 1; Complaint, Sec. & Exch. Comm'n v. Wahi, No. 2:22-cv-01009 (W.D. Wash. July 21, 2022), ECF No. 1.

[3] Judgment in a Criminal Case, United States v. Wahi, No. 1:22-cr-00392 (S.D.N.Y. Jan. 10, 2023), ECF No. 68; Press Release, Dep't of Justice, Former Coinbase Insider Pleads Guilty In First-Ever Cryptocurrency Insider Trading Case, Feb. 7, 2023, available at https://www.justice.gov/usao-sdny/pr/former-coinbase-insider-pleads-guilty-first-ever-cryptocurrency-insider-trading-case.

[4] Complaint at ¶ 90, Sec. & Exch. Comm'n v. Wahi, No. 2:22-cv-01009 (W.D. Wash. July 21, 2022), ECF No. 1.

[5] Shortly after the Wahi charges were announced, Coinbase issued a terse statement that it "does not list securities. End of story." Paul Grewal, Coinbase does not list securities. End of story, Coinbase Blog (July 21, 2022), available at https://www.coinbase.com/blog/coinbase-does-not-list-securities-end-of-story. Moreover, the company filed a petition with the SEC, criticizing the current regulatory framework for securities as ineffective, and urging the agency to develop new rules around the regulation of digital assets. See Letter from Paul Grewal, Coinbase Global, Inc., to Vanessa A. Countryman, Sec. & Exch. Comm'n (July 21, 2022), available at https://www.sec.gov/rules/petitions/2022/petn4-789.pdf. None of these efforts have deterred the SEC's Enforcement Division from taking further action against crypto companies. Most recently, the SEC charged cryptocurrency lender, Genesis Global Capital, and cryptocurrency exchange, Gemini Trust, with offering unregistered securities. See Press Release, Sec. & Exch. Comm'n, SEC Charges Genesis and Gemini for the Unregistered Offer and Sale of Crypto Asset Securities through the Gemini Earn Lending Program, Jan. 12, 2023, available at https://www.sec.gov/news/press-release/2023-7.

[6] United States v. Chastain, No. 22-CR-305 (JMF), 2022 WL 13833637 (S.D.N.Y. Oct. 21, 2022).

[7] Id. at *1-3.

[8] Complaint at ¶5, Sec. & Exch. Comm'n v. Panuwat, No. 3:21-cv-06322 (N.D. Cal. Aug. 17, 2021), ECF No. 1.

[9] Sec. & Exch. Comm'n v. Panuwat, No. 3:21-CV-06322, 2022 WL 633306, at *8 (N.D. Cal. Jan. 14, 2022).

[10] See Press Release, Sec. & Exch. Comm'n, SEC Adopts Amendments to Modernize Rule 10b5-1 Insider Trading Plans and Related Disclosures (Dec. 14, 2022), available at https://www.sec.gov/news/press-release/2022-222 (SEC Chair Gary Gensler: "Over the past two decades, though, we've heard from courts, commenters, and members of Congress that insiders have sought to benefit from the rule's liability protections while trading securities opportunistically on the basis of material nonpublic information.").

[11] Sientra, Inc., Form 10-Q for the period ended Sept. 30, 2022 at 25.

[12] Press Release, Sec. & Exch. Comm'n, SEC Charges Cheeta Mobile's CEO and its Former President with Insider Trading, Sept. 21, 2022, available at https://www.sec.gov/news/press-release/2022-169.

[13] S. 2038 — 112th Congress: STOCK Act § 3 (2012), available at https://www.congress.gov/112/plaws/publ105/PLAW-112publ105.pdf.

[14] William A. Powers, Is Crypto a Security or Commodity? Look to Congress's Ethics Rules, Bloomberg Tax, July 14, 2022, available at https://news.bloombergtax.com/crypto/is-crypto-a-security-or-commodity-look-to-congress-ethics-rules.

[15] Dareh Gregorian, Burr, other senators under fire for stock sell-offs amid coronavirus outbreak, NBC News, Mar. 19, 2020, available at https://www.nbcnews.com/politics/congress/aoc-calls-senate-intel-chair-richard-burr-resign-stock-selloff-n1164401.

[16] See H.R. 8990 — 117th Congress: Combatting Financial Conflicts of Interest in Government Act (2022), available at https://www.congress.gov/bill/117th-congress/house-bill/8990; S. 3504 — 117th Congress: Banning Insider Trading in Congress Act (2022), available at https://www.congress.gov/bill/117th-congress/senate-bill/3504?r=53&s=1.

[17] See Kate Kelly, Adam Playford and Alicia Parlapiano, Stock Trades Reported by Nearly a Fifth of Congress Show Possible Conflicts, N.Y. Times, Sept. 13, 2022, available at https://www.nytimes.com/interactive/2022/09/13/us/politics/congress-stock-trading-investigation.html; Dave Levinthal, 77 members of Congress have violated a law designed to prevent insider trading and stop conflicts-of-interest, Insider, Dec. 15, 2022, available at https://www.businessinsider.com/congress-stock-act-violations-senate-house-trading-2021-9.

[18] Id.

[19] Karl Evers-Hillstrom, Three in four voters support banning lawmakers from trading stocks: poll" The Hill, Jan. 6, 2022, available at https://thehill.com/homenews/news/588630-76-percent-of-voters-

support-banning-lawmakers-from-trading-stocks-poll/.

[20] William Belmont, Bruce Sacerdote, Ranjan Sehgal & Ian Van Hoek, Relief Rally: Senators As Feckless As the Rest of Us at Stock Picking, National Bureau of Economic Research, Apr. 2020, available at https://www.nber.org/papers/w26975.

[21] See, e.g., Kate Kelly, SEC Inquiry Into Former Senator's Stock Sales is Closed Without Charges, N.Y. Times, Jan. 6, 2023, available at https://www.nytimes.com/2023/01/06/us/politics/burr-sec-inquiry-closed.html; Dan Mangan, DOJ will not criminally charge Sen. Richard Burr for stock trades he made after getting Covid intelligence, CNBC, Jan. 19, 2021, available at https://www.cnbc.com/2021/01/19/doj-will-not-charge-sen-richard-burr-for-covid-stock-trades.html.