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CLIENT ALERT

SEC Enforcement – Top Four Developments from April 2024

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In April, the U.S. Securities and Exchange Commission (the "SEC" or "Commission") logged courtroom wins in closely watched insider trading and crypto actions. The Commission also instituted its first off-channel communications action involving a standalone investment adviser and the second round of settled actions under the Advisers Act Marketing Rule. In this alert, we briefly summarize the top four securities enforcement developments from the last month, including:

- The SEC's win at trial on its novel "shadow" insider trading theory;
- The first recordkeeping enforcement action brought against a standalone investment adviser;
- A prominent crypto-asset issuer and its founder being found liable for securities fraud; and
- The second round of the SEC's Marketing Rule enforcement sweep.

1. SEC Prevails on “Shadow” Insider Trading Theory

On April 5, a jury in the Northern District of California found in favor of the SEC in *SEC v. Panuwat*, the first test of the Commission’s novel “shadow” insider trading theory.[1] Panuwat, a pharmaceutical executive, received material non-public information (“MNPI”) that his company would soon be acquired by a significantly larger, multinational firm. Using this knowledge, Panuwat purchased securities issued by a different—but comparable—company that Panuwat anticipated would benefit from sector-wide enthusiasm following the announcement of the acquisition. After an eight-day trial, the jury found Panuwat liable for insider trading. If upheld on appeal, this “shadow” insider trading theory, where an insider’s use of MNPI obtained regarding one company, but which may also constitute MNPI for another, related company, thus creating liability for the insider’s trading in the securities of the other company, would significantly expand the scope of culpable conduct for insider trading.

The SEC brought its claim against Panuwat under the misappropriation theory of insider trading, where liability arises based on misuse of information in breach of a duty to the source of the information.[2] The Commission argued that Panuwat’s conduct constituted a straightforward breach of a duty he owed the source of the MNPI, his employer. In support of its argument, the SEC cited the Panuwat’s senior title, the confidentiality agreement he entered into with his company, and his company’s expansive insider trading policy, all of which the SEC argued directly or indirectly proscribed his conduct. The SEC further argued—and the jury agreed—that a sufficient “market connection” existed between the two companies such that the same information could be material to both companies.

Notwithstanding the apparent novelty of the Commission’s theory, the SEC’s press release following the jury verdict asserted that “there [wa]s nothing novel about” its application of the misappropriation theory to an insider’s trading in the securities of a third party. For the Commission, the theory it advanced was insider trading, “pure and simple.” However, the SEC conceded at oral argument that there “appear[ed] to be no other cases where the [MNPI] at issue involved a third party.”[3]

Time will tell if the unique facts at issue will limit the “shadow” trading theory’s application to this case alone, but the SEC’s success on this theory has, for the time being, broadened the universe of potentially culpable conduct for insider trading violations. Companies and their directors and officers should take care to review their insider trading and confidentiality policies, with consultation from experienced counsel, to evaluate those policies in light of the developments in *Panuwat*.

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1 The Order denying the defendant’s Motion to Dismiss, which allowed the SEC’s theory to proceed, is available here; *see also SEC v. Panuwat*, No. 1:21-cv-06322-WHO, 2023 WL 9375861 (N.D. Cal. Nov. 20, 2023) (Order denying defendant’s motion for summary judgment).

2 *United States v. O’Hagan*, 521 U.S. 642, 651-52 (1997).

3 *Compare* the SEC’s statement on the jury verdict, available here, *with* Order denying defendant’s Motion to Dismiss, at 12.

2. First Off-Channel Enforcement Action Against Standalone Investment Adviser

On April 3, the SEC brought its first enforcement action for off-channel communications against an investment adviser that was not dually-registered as a broker-dealer or affiliated with one.[4] Though this is the first recordkeeping action against a standalone investment adviser, it follows a long and growing line of nearly 60 such actions. The investment adviser agreed to pay a $6.5 million penalty.

The SEC's Order also contained a number of other notable takeaways.[5] As in recordkeeping actions against broker-dealers, the Order required the adviser to admit to the facts and agree to significant undertakings, including the retention of an independent compliance consultant.

In addition to violations of the recordkeeping rules and a failure to supervise, this action also included a violation of the Advisers Act Compliance Rule. This is the first off-channel action to include a Compliance Rule charge and is a reminder to registered investment advisers regularly to review their policies and procedures to ensure that they correspond with the adviser's actual practices.

3. Crypto-Asset Issuer and Founder Found Liable for Securities Fraud, SEC Requests $5.3 Billion Fine

On April 5, a jury in the U.S. District Court for the Southern District of New York ("SDNY") found Terraform Labs ("Terra") and its founder liable on securities fraud charges following the collapse of Terra's flagship product, the algorithmic stablecoin Terra USD, and the related token LUNA.[6] Terra and its founder are alleged to have caused approximately $40 billion in losses for investors, and made more than $4 billion from sales of their tokens. This litigation has been closely watched in the wake of Judge Rakoff's summary judgment opinion, which rejected the approach adopted by the court in *SEC v. Ripple Labs Inc*.[7]

On April 19, the SEC requested that the Court enter final judgment against Terra and its founder, and that they jointly pay approximately $4.2 billion in disgorgement, plus approximately $546 million in prejudgment interest.[8] The SEC also requested that the Court order Terra and its founder to pay $420 million and $100 million fines, respectively. Terra argued that the SEC was not entitled to seek disgorgement, and that Terra should, at most, pay a $1 million civil penalty.

Click here to read the previous Willkie Client Alert addressing the Terra litigation.

4 The SEC's press release is available here.

5 The SEC's Order is available here.

6 The SEC's press release is available here.

7 *SEC v. Terraform Labs PTE Ltd.*, 684 F.Supp. 170 (S.D.N.Y. Jul. 31, 2023) (Opinion and Order denying motion to dismiss).

8 SEC's Motion for Final Judgment, *SEC v. Terraform Labs PTE Ltd.*, No. 1:23-cv-01346-JSR, ECF No. 231 (S.D.N.Y. Apr. 19, 2024).

4. SEC Charges Five Investment Advisers with Marketing Rule Violations in Second Sweep

On April 12, the SEC settled charges with five investment advisers for violations of the Advisers Act Marketing Rule, with the firms agreeing to pay $200,000 in combined penalties.[9] The advisers were charged with, *inter alia*, advertising hypothetical performance to the general public without having adopted and implemented policies and procedures reasonably designed to ensure that the advertised hypothetical performance was relevant to the likely financial situation and financial objectives of the advertisements' targeted audiences. This second sweep follows the Commission's earlier September 11, 2023 Marketing Rule sweep, which settled Marketing Rule violation charges with nine investment advisers for a total of $850,000 in combined penalties.

As is typical of SEC enforcement of a new rule, the second sweep enforced additional elements of the Marketing Rule which were absent from the first sweep. These additional elements included, but were not limited to: advertising misleading model performance; being unable to substantiate performance shown in advertisements; and failing to enter into written agreements with persons the advisers compensated for endorsements. By contrast, the first sweep focused primarily on the advisers' failure to adopt and implement written policies and procedures designed to comply with the Marketing Rule.

These actions show the Commission's continued focus on enforcement of the Marketing Rule. And, the press release suggests significant cross agency-collaboration. Specific acknowledgements were given in the press release to contributions from the Staff of multiple offices and divisions, including the Divisions of Enforcement, Examinations, Investment Management, and Economic and Risk Analysis.

Click here to read this Willkie Client Alert regarding a recent Risk Alert from the SEC's Division of Examinations regarding Marketing Rule compliance.

9 The SEC's press release is available here.

If you have any questions regarding this client alert, please contact the following attorneys or the Willkie attorney with whom you regularly work.

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