Clients&FriendsMemo

Shadow Trading Expands Potential Insider Trading Liability in *S.E.C. v. Panuwat*

April 19, 2024

Insider trading generally refers to the trading of a company's security based upon material non-public information ("MNPI") ***about that company***. But a recent litigation victory by the U.S. Securities and Exchange Commission ("SEC") is premised on allegations of "shadow trading," expanding insider trading to a misappropriation of confidential information about one company to trade in securities of a second company where there is a sufficient business connection between the two companies. In other words, material information about one company is material to another company because of their market relationship – the idea that they are "economically-linked."[1] The theory stems from an existing insider trading liability theory, the misappropriation theory, whereby someone "knowingly misappropriate[s] confidential, material, and nonpublic information for securities trading purposes, in breach of a duty arising from a relationship of trust and confidence owed to the source of the information."[2]

The novel case is *S.E.C. v. Panuwat*. On April 5, 2024, after less than three hours of deliberations, a jury in the Northern District of California found Matthew Panuwat, former employee of California-based biopharmaceutical company Medivation, liable for insider trading based on his trading in a second, entirely separate company, Incyte. The jury's verdict marks a notable expansion of the scope of exposure under insider trading laws, increases the prospect of criminal prosecutions under the shadow trading theory, and raises important considerations for companies with regard to insider trading policies and trainings.

Background

On August 18, 2016, Panuwat, then a senior executive at Medivation, received an email from Medivation's CEO, David Hung, that an acquisition of Medivation by Pfizer was imminent.[3] Seven

[1] Mihir N. Mehta et al., *Shadow Trading*, The Acct. Rev. 1 (July 2021) https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3689154

[2] *See e.g. S.E.C. v. Talbot*, 530 F.3d 1085, 1092 (9th Cir., 2008).

[3] *See S.E.C. v. Panuwat*, No. 3:21-CV-06322, Compl. ¶ 30, ECF No. 1, Aug. 17, 2021.

minutes later Panuwat purchased call options in Incyte.[4] The SEC alleged that though Incyte is a different company, it is "strikingly similar to Medivation" and M&A presentations to investment banks by Medivation referred to Incyte as a "peer company."[5] When the acquisition was publicly announced on August 22, 2016, Incyte's stock price went up 8 percent.[6] Two days later, Panuwat sold his Incyte options for a profit of $107,066.[7]

The SEC filed its civil complaint against Panuwat on August 17, 2021, alleging that Panuwat, in breach of his duty to Medivation, used the confidential information regarding Medivation's impending acquisition, which was material not only to Medivation but also to Incyte, to trade in Incyte.[8]

Legal Issues

Interestingly, the SEC disagrees that *Panuwat* involves a novel theory, and instead views this action as consistent with the misappropriation theory for insider trading. In the seminal case on this issue, *United States v. O'Hagan*, the U.S. Supreme Court recognized the validity of the misappropriation theory if four elements are satisfied: (1) a lie or deception; (2) a transgression of a fiduciary obligation; (3) the use of material non-public information in relation to a securities transaction; and (4) willfulness by the defendant. In that case, the insider, an attorney, had access to confidential information about an imminent tender offer, but did not owe any duty of trust or confidence to the target or its shareholders, in which the attorney purchased stock before the tender offer was made. The Supreme Court, in upholding the misappropriation theory, explained that it "is thus designed to 'protec[t] the integrity of the securities markets against abuses by 'outsiders' to a corporation who have access to confidential information that will affect th[e] corporation's security price when revealed, but who owe no fiduciary or other duty to that corporation's shareholders."

Applying this theory, throughout the *Panuwat* case, and at trial, three issues loomed large: (1) the materiality *as to Incyte* of the information Panuwat received, (2) whether Panuwat breached a duty to Medivation by purchasing and selling stock in Incyte and (3) whether Panuwat acted with the intent to defraud. There was no question that the information that Panuwat received was non-public. Therefore, unlike in *O'Hagan* where the trading involved an acquisition target, the SEC had to establish in *Panuwat* that information about the acquisition of one company was material to an entirely separate company.

Information becomes material when it would be of interest to a "reasonable investor" making an investment decision. There are qualitative and quantitative factors in assessing materiality. In *Panuwat*,

[4] *See id.* at ¶ 33.

[5] *See id.* at ¶¶ 21-22.

[6] *See id.* at ¶ 37.

[7] *See id.* at ¶ 38.

[8] *See generally id.*

the SEC relied on the movement in the Incyte stock after the Medivation acquisition announcement to support its theory of materiality. However, there are always challenges in simply pointing to unusual movement in a security to make this argument. Any analysis has to control for other market information and industry news, which the defense tried to point to here, focusing on the available market information about *Incyte* as the basis for Panuwat's trading. The qualitative analysis is related – what matters to the market and industry and to what extent this was anticipated.

The District Court had previously denied Panuwat's motion to dismiss, considering the materiality argument and holding that information did not need to be material to Medivation, but material to "any security," for the case to proceed.[9] There was also consideration of whether any duty existed between Panuwat and Incyte. The defense's arguments were weakened by language in Medivation's policies, which explicitly limited trading based on MNPI in "the securities of another publicly traded company."[10]

At trial, the jury agreed with the SEC's shadow trading theory and found that Panuwat's purchase of Incyte options constituted insider trading in violation of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5.[11]

Takeaways

Panuwat was an important test for the SEC in its effort to expand liability for insider trading. A Ninth Circuit appeal is likely and will be closely watched. While it remains to be seen whether the Department of Justice will rely on shadow trading as the basis for criminal charges, *Panuwat* sets a significant precedent for potential criminal insider trading charges.

There are, of course, important considerations for in-house counsel. Insider trading policies should be reviewed annually. While many companies' policies already state that information about third parties, such as collaboration partners or M&A targets, gained in the course of work for the company cannot be used to trade securities of such third parties, *Panuwat* may necessitate broadening that prohibition. Companies should consider "shadow trading" issues relevant to their respective industries, including whether it may be necessary to preclude trading in peer or competitor companies, as well as publicly-traded customers and vendors.

Notably, Medivation's policies included a duty to abstain from using MNPI to trade in another company's securities, which the court and jury both found significant in terms of assessing Panuwat's

[9] *See S.E.C. v. Panuwat*, No. 21-CV-06322-WHO, 2022 WL 633306, at *4 (N.D. Cal. Jan. 14, 2022).

[10] *Id.* at *6.

[11] *See S.E.C. v. Panuwat*, No. 3:21-CV-06322, Verdict Form, ECF No. 169, Apr. 5, 2024.

intent and duty. Companies should regularly train employees on their insider trading policies and monitor compliance with such policies.

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