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SEC's New Insider "Shadow Trading" Theory Survives Its First Test

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The Securities and Exchange Commission (SEC) is testing the bounds of insider trading laws (as previously reported here), and it recently survived the first challenge to its newest theory. On January 14, the U.S. District Court for the Northern District of California issued a decision in *SEC v. Panuwat*, No. 3:21-cv-06322-WHO (N.D. Cal.), supporting the SEC's legal theory that "shadow trading" can violate securities law(s).[1]

SEC v. Panuwat

In *Panuwat*, the SEC alleged that Matthew Panuwat was a senior director at Medivation, Inc. — a "mid-cap, oncology-focused biopharmaceutical company." Panuwat's job responsibilities included working closely with other executives and with investment bankers to explore Medivation's options for merging with another company. Minutes after Medivation's CEO advised Panuwat and other executives that Pfizer, Inc., wanted to acquire Medivation, Panuwat purchased call options in a company called Incyte, Inc., which Panuwat previously identified for the investment bankers as one of Medivation's close peer companies.

After announcing the Medivation-Pfizer merger, Medivation's share price jumped 20%, and other mid-cap biopharmaceutical companies' share prices also increased, including Incyte's. As a result of his call options, Panuwat earned $107,666 in profits. On August 17, 2021, the SEC brought suit, alleging that Panuwat violated Section 10(b) of the Exchange Act and Rule 10b-5 by purchasing Incyte options after learning of Medivation's likely merger with Pfizer.

Panuwat's Motion to Dismiss

Panuwat moved to dismiss the SEC's lawsuit and asserted that the complaint failed to adequately plead: (1) that the information at issue was material and nonpublic; (2) that Panuwat breached his duty to Medivation; and (3) that Panuwat acted with scienter. Panuwat also asserted that the SEC's novel theory improperly seeks to expand securities laws and would violate Panuwat's due process rights.

The court rejected each of these arguments. The court found that the broad language of the securities laws allows for insider information of one company to be material to more than one company, reasoning that the laws broadly prohibit insider trading of "*any* security" using "*any* manipulative or deceptive device." The court noted that nothing in the laws provide that information "about that security or issuer" must come from the same security or issuer itself to be material.

The court also rejected Panuwat's argument that he did not breach his duty to Medivation by trading in Incyte's securities. The court explained that Medivation's *own* insider trading policy broadly prohibited trading in "securities of another publicly traded company," which included Incyte. The court also found that the SEC had sufficiently alleged that Panuwat acted with scienter because the allegations in the complaint — that Panuwat purchased Incyte's stock within minutes of receiving the email indicating that a deal with Pfizer was imminent — was sufficient circumstantial evidence to indicate that Panuwat acted with the requisite scienter.

Finally, the court rejected Panuwat's argument that the SEC's claim — "that confidential information regarding an acquisition involving Company A should also be considered material to Company B (and presumably companies C, D, E, etc.) that operate within the same general industry" — stretches the misappropriation theory beyond what comports with due process. While the court acknowledged that the SEC's lawsuit is pursuing a first-of-its-kind theory, the court found that the expansive language of Section 10(b) allowed for such an action. The court reasoned that the scope of the law was not limitless, but instead that "scienter and materiality provide sufficient guardrails to insider trading liability."

Takeaways

The *Panuwat* decision is limited to the facts before the court — a uniquely situated employee who used material nonpublic information about his employer to profit from trading in a peer company's securities in a niche market — and was merely the denial of a motion to dismiss.

However, the court's analysis and reasoning also can be seen as judicial support for an expansive interpretation of Section 10b and Rule 10b-5 that could extend to other instances of "shadow trading." Companies and individuals will need to carefully consider the extent to which the *Panuwat* analysis could apply to other facts and whether their insider trading policies should be revised in light of *Panuwat*.

The outcome of *Panuwat* will likely dictate whether courts will be asked to further identify what constitutes impermissible "shadow trading," but a slight variation of the facts could have drastically changed the outcome in this case: What if Panuwat had purchased securities in one of Medivation's suppliers or customers that would have been affected by the merger, or purchased securities in a large- or small-cap "oncology-focused biopharmaceutical company," or bought shares in a fund with holdings comprised of oncology-focused biopharmaceutical companies that were not all close competitors of Medivation? Expect courts to contend with defining the scope of shadow trading if the SEC's *Panuwat* test case succeeds.

Alternatively, given that the court supported its decision by relying on Medivation's own insider trading policy, what if Medivation had a narrower policy that did not mention other companies or if it had no insider trading policy? In such cases, could the SEC pursue a case? It seems that such a theory of liability that depends on the language of an employer's insider trading policy to be unequal, unfair, and unsustainable will be a focus as this continues to be judicially reviewed.

In the meantime, if you have any questions regarding this article or your company's policies and procedures to address "shadow trading," please contact any of the Troutman Pepper attorneys listed on this advisory.

[1] “Shadow trading” is a phrase that refers to the practice in which corporate insiders use confidential nonpublic information to facilitate trading in economically linked firms in an effort to avoid insider trading laws. *See* Mehta, Reeb, and Zhao, “Shadow Trading,” 96 Account. Rev. 367 (2021), available here.

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