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SEC Successfully Prosecutes Novel "Shadow Trading" Theory at Trial

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The government successfully argued that trading in the securities of one company based upon material nonpublic information about a separate company (in whose securities the defendant does not trade) can nevertheless violate the federal securities laws. On April 5, 2024, a civil jury found a former biopharmaceutical executive liable for insider trading under a novel theory with potentially far-reaching implications for the government's enforcement of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder, as well as potential criminal insider trading prosecutions. In a first-of-its-kind trial, in *SEC v. Panuwat*, the government successfully argued that trading in the securities of one company based upon material nonpublic information about a separate company (in whose securities the defendant does not trade) can nevertheless violate the federal securities laws. This is called "shadow trading." Although the SEC has been at pains to claim that there is "nothing novel" about the "pure and simple" insider trading theory it advanced in *Panuwat*,[1] the ruling heralds a significant new application of the federal government's insider trading authority to prevent such "shadow trading" in which corporate insiders allegedly exploit information about their own companies to profit by trading in the securities of "economically-linked firms."[2] **Factual Background** Matthew Panuwat served as Senior Director of Business Development at Medivation Inc., a publicly traded biopharmaceutical company specializing in oncology drugs. At the outset of his employment, Mr. Panuwat signed the company's insider trading policy. That policy provided that he would not "gain personal benefit" by using Medivation's information to "profit financially by buying or selling" *either* Medivation's securities "*or* the securities of another publicly traded company."[3] Not all public companies prohibit their personnel (including members of the Board of Directors) from trading in the securities of other public companies or competitors. Medivation did. As alleged by the government, on August 18, 2016, Mr. Panuwat and other senior employees received an email from David Hung, Medivation's chief executive officer, suggesting that a deal was imminent in which Medivation would be purchased by Pfizer. Although market participants already knew that Medivation had been fielding offers for several months, the SEC alleged that Hung's email contained several pieces of non-public information. Mr. Panuwat, who had been part of the Medivation deal team, knew that the bids from potential acquirers including Pfizer represented a substantial premium over the then-existing market price for Medivation shares. Seven minutes after receiving Mr. Hung's email, Mr. Panuwat began purchasing call options for Incyte Corporation, one of a handful of similar publicly traded biopharmaceutical companies focused on late-stage oncology treatments. When Pfizer's acquisition of Medivation was publicly announced a few days later, Incyte's stock increased 7.7% and Mr. Panuwat made approximately $110,000 from his call options. On August 17, 2021, the SEC brought an action against Mr. Panuwat for insider trading under Section 10(b) of the Exchange Act, alleging a single violation of Rule 10b-5. **The District Court Denied Mr. Panuwat's Motion to Dismiss** Mr. Panuwat moved to dismiss the SEC's complaint on multiple grounds, including that the SEC's unprecedented "shadow trading" theory sought to hold him liable for trading in Incyte's securities as a result of his knowledge of the Pfizer-Medivation acquisition violated his constitutional right to Due Process. Mr. Panuwat argued that such a theory had never before been advanced in litigation. According to this line of argument, market participants had not previously understood 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."[4] Although the Court agreed that

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there “appear to be no other cases” supporting that proposition, and the SEC “conceded this at oral argument,” the Court nevertheless rejected this Due Process argument. The Court held that the SEC’s theory fell “within the general framework of insider trading, and the expansive language” of federal securities laws.[5] The lengthiest portion of the Court’s decision, as well as the parties’ briefing, concerned whether information regarding the Pfizer-Medivation acquisition was material to Incyte. Mr. Panuwat argued that the information he received was not “about” Incyte, a non-party to the imminent transaction.[6] But the Court concluded that “given the limited number of mid-cap, oncology-focused biopharmaceutical companies with commercial-stage drugs in 2016, the acquisition of one such company (Medivation) would make the others (*i.e.*, Incyte) more attractive, which could then drive up their stock price.” The Court stated that it was “reasonable to infer” that other companies that had unsuccessfully attempted to acquire Medivation “would turn their attention to Incyte” after losing out to Pfizer.[7] And, more broadly, in *dicta* the Court endorsed the SEC’s “common-sense” argument that “information regarding business decisions by a supplier, a purchaser, or a peer can have an impact on a company” and therefore be material—a potentially far-reaching endorsement of the SEC’s novel “shadow trading” theory.[8] In addition, the parties agreed that Mr. Panuwat owed a duty to Medivation in light of his role as a senior executive of the company. That supported the SEC’s theory that he could be liable for misappropriating Medivation’s material non-public information concerning its impending acquisition. Although Mr. Panuwat argued that trading Incyte securities did not violate his duties to Medivation, the Court disagreed. At the pleading stage, the Court relied on “the plain language” of Medivation’s insider trading policy prohibiting trading “‘the securities of another publicly traded company, including . . . competitors” of Medivation, which could be read to include Incyte.[9] The Court further found that *scienter* could be reasonably inferred given that Mr. Punawat allegedly traded the Incyte call options “within minutes” of receiving Mr. Hung’s email but had “never traded Incyte stock before.”[10] **A Jury Agrees Mr. Panuwat’s Trading Falls Within the SEC’s “Shadow Trading” Theory** In November 2023, the Court denied Mr. Panuwat’s motion for summary judgment. The Court found that a key question for the jury was whether the SEC could prove “a connection between Medivation and Incyte” such that “a reasonable investor would view the information in the Hung Email as altering the ‘total mix’ of information available about Incyte.”[11] In particular, the Court recognized at least three ways in which the SEC might be able to prevail on this question of fact. First, it recognized that the SEC had introduced several “analyst reports and financial news articles” that “repeatedly linked Medivation’s acquisition to Incyte’s future.”[12] Mr. Panuwat tried to sever this link by arguing that Medivation and Incyte did not consider themselves competitors because they offered somewhat different products. The Court, however, rejected this argument because “no legal authority suggest[ed] that a reasonable investor would conclude that Medivation’s acquisition would only affect the stock price of companies that directly competed” with it.[13] Second, the SEC introduced evidence that “Medivation’s investment bankers considered Incyte a ‘comparable peer’” for valuation purposes because both were mid-cap biopharmaceutical companies with cancer-related drugs.[14] Third, the Court found that Incyte’s stock price increased by 7.7% after announcement of the Pfizer-Medivation acquisition, which the Court inferred was itself “strong evidence” investors understood “the significance of that information” as being material to Incyte.[15] *SEC v. Panuwat* proceeded to an eight-day jury trial that began on March 25, 2024. After only about two hours of deliberation, on April 5, the jury returned a verdict finding that Mr. Panuwat’s purchase of Incyte call options constituted insider trading in violation of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder. That same day the SEC issued a press release noting that the brevity of the jury’s deliberations supported the SEC’s position since the outset of the litigation, quoting Division of Enforcement Director Gurbir S. Grewal as saying that, “As we’ve said all along, there was nothing novel about this matter, and the jury agreed: this was insider trading, pure and simple” because Mr. Panuwat “used highly confidential information about an impending announcement” of Medivation’s acquisition “to trade ahead of the news for his own enrichment” by using “his employer’s confidential information to acquire a large stake in call options” of Incyte, which “increased materially on the important news.”[16]

Depending on the Appellate Court, “Shadow Trading” Liability May Be Here to Stay

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Pending the results of the anticipated appeal, the successful prosecution of Mr. Panuwat has armed the federal government with a powerful new precedent. Academic studies have claimed to find "robust evidence" that "shadow trading" is a frequent real-world phenomena in which "employees circumvent insider trading regulations" by "trading in their firm's business partners and competitors" rather than trading in their own employers' securities.[17] The district court's detailed rulings in *SEC v. Panuwat* provide a clear blueprint for the government's approach moving forward. Further, the jury's findings against Mr. Panuwat after deliberating for only a few hours provides anecdotal evidence that litigating "shadow trading" cases is a viable option for government regulators and prosecutors. Depending on whether Mr. Panuwat appeals the decision (as expected), legal and compliance professionals would be well-advised to continue to keep "shadow trading" issues in mind when designing, revising and implementing their firms' trading policies and training programs. Indeed, anyone who trades in securities while in possession of material non-public information—including corporate insiders and directors, bankers, accountants, and lawyers, among others—could find themselves within the zone of a "shadow trading" theory. In addition, commencing with annual reports on Forms 10-K for fiscal years beginning on or after April 1, 2023, public companies will need to file as an exhibit to their Form 10-Ks any "insider trading policies and procedures governing the purchase, sale, and/or other dispositions *of the registrant's securities*" that "are reasonably designed to promote compliance with insider trading laws, rules and regulations."[18] While this requirement does not literally apply to policies addressing the trading of other companies' securities, some companies have policies (as with Medivation) that address such trading.[19] Companies should carefully consider all factors in deciding whether to prohibit trading in other securities, and conduct training of insiders and board members as to the SEC's expansive views on the scope of the law against insider trading. Moreover, the securities laws impose obligations on SEC-registered firms, namely investment advisers and broker-dealers, to adopt and implement policies and procedures reasonably designed to prevent the misuse of material nonpublic information. Such firms can often be confronted with questions as to the scope of a restriction imposed by the receipt of material nonpublic information subject to a duty of confidentiality, while simultaneously fulfilling fiduciary duties to manage assets in the interests of clients. Such questions can arise at the inception of a trading restriction as well as at later points during the period of restriction. Judgments about the materiality of information about one company to the price of securities of another company are particularly nuanced and complicated. For example, it can be difficult to determine whether favorable news about one company will have a positive or negative impact on a competitor. Hanging over all of this is the ever-present risk that the SEC views the facts with the benefit of hindsight. Legal and compliance functions at investment advisers and broker-dealers may wish to revisit their policies and procedures in light of the shadow trading risk, as well as train their investment professionals to be sensitized to the risks the case highlights. As always, Gibson Dunn remains available to help its clients in addressing these issues. [1] SEC, *Statement on Jury's Verdict in Trial of Matthew Panuwat*, Apr. 5, 2024 https://www.sec.gov/news/statement/grewal-statement-040524. [2] Mihir Mehta, David Reeb, & Wanli Zhao, *Shadow Trading* 1, Accounting Review (July 2021), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3689154. [3] Complaint ¶ 20, *SEC v. Panuwat*, No. 21-cv-06322 (N.D. Cal. Aug. 17, 2021) [4] *SEC v. Panuwat*, 2022 WL 633306, at *8 (N.D. Cal. Jan. 14, 2022). [5] *Id.* [6] *Id*. at *4. [7] *Id*. at *5. [8] *Id*. at *4. [9] *Id.* at *6. [10] *Id*. at *7. [11] *SEC v. Panuwat*, 2023 WL 9375861, at *5 (N.D. Cal. Nov. 20, 2023). [12] *Id*. at *6. [13] *Id*. [14] *Id*. [15] *Id*. [16] SEC, *Statement on Jury's Verdict in Trial of Matthew Panuwat*, Apr. 5, 2024 https://www.sec.gov/news/statement/grewal-statement-040524. [17] Mihir Mehta, David Reeb, & Wanli Zhao, *Shadow Trading* 1, 4, Accounting Review (July 2021), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3689154. [18] Item 408(b) of Regulation S-K (emphasis added). Smaller reporting companies have to comply with the requirements beginning with their Form 10-K for fiscal years beginning on or after October 1, 2023. [19] Under Section 21A(b)(1) of the Exchange Act, public companies are not subject to controlling person liability for insider trading by executives, directors, or employees unless they disregarded the fact that a controlled person was likely to engage in the act or acts constituting the violation and failed to take appropriate steps to prevent

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such act or acts before they occurred.

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