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SEC Defeats Motion to Dismiss Insider-Trading Complaint Alleging Novel “Shadow Trading” Theory

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The SEC prevailed on a motion to dismiss a closely watched lawsuit alleging that the defendant had engaged in insider trading based on news about a not-yet-public corporate acquisition when he purchased securities of a company not involved in that deal. The January 14, 2022 decision in *SEC v. Panuwat* (N.D. Cal.) marks the first time a court has considered the theory of “shadow trading,” which involves trading the securities of a public company that is not the direct subject of the material, nonpublic information (“MNPI”) at issue.

The *Panuwat* decision does not appear to break new ground under the misappropriation theory of insider trading in light of the particular facts alleged. But the “shadow trading” theory warrants attention because, on other sets of allegations, it can have wide-ranging ramifications for traders.

Factual Background

The facts of the complaint, described in detail here, involved Matthew Panuwat, the then-head of business development at a pharmaceutical company called Medivation. The SEC alleged that Panuwat had learned that Medivation was on the verge of being acquired by a large pharmaceutical firm and that, before the acquisition was announced, he had purchased call options on securities issued by one of Medivation’s competitors, Incyte.

The SEC’s theory was that several potential acquirors had been interested in buying Medivation, that Incyte was one of a “limited number of mid-cap” companies in Medivation’s area of business, that Incyte would become more attractive to potential acquirors once the Medivation deal was announced, and that Incyte’s stock price would increase as a result. The facts allegedly supported the SEC’s theory: when the Medivation deal was announced, Incyte’s stock price rose, and Panuwat made $107,066 on his call options.

The Court’s Decision

Panuwat moved to dismiss the SEC's complaint on two grounds. First, he argued that the SEC's complaint had failed to satisfy three elements of the misappropriation theory of insider trading: materiality, breach of duty, and scienter. Second, he asserted that the SEC's allegations violated his due-process rights because the shadow-trading theory inappropriately expanded insider-trading law beyond its generally understood parameters and thereby failed to provide adequate notice of what the law prohibits. The court disagreed and denied Panuwat's motion to dismiss.

Materiality

The court began by addressing the parties' materiality contentions, which constituted the "bulk of the parties' arguments." It first evaluated the parties' competing readings of whether information about Incyte – which was not the direct subject of the MNPI about the Medivation acquisition – could be material under Section 10(b) of the Securities Exchange Act and SEC Rules 10b-5 and 10b5-1(a). Panuwat argued that Rule 10b5-1(a) required the SEC to prove he had traded Incyte securities on the basis of MNPI about Incyte itself; the SEC asserted that Rule 10b5-1(a) is not exhaustive and that trading in connection with "any security" could violate Section 10(b).

The court agreed with the SEC's interpretation. It held that Section 10(b) and Rule 10b-5 "cast a wide net" to prohibit insider trading of "*any* security" and that neither of those provisions nor Rule 10b5-1(a) requires the information to come from or be about the issuer itself (*i.e.*, Incyte). The court read the Supreme Court's decision in *Basic Inc. v. Levinson*, 485 U.S. 224 (1988), as focusing on whether the information is significant to the security issuer without "foreclos[ing] the possibility that information may be significant to an issuer even if it comes from outside the company."

Applying the SEC's reading, the court found it reasonable to infer at the pleading stage that Panuwat's MNPI about the Medivation acquisition would be significant to Incyte in light of "the limited number of mid-cap, oncology-focused biopharmaceutical companies with commercial-stage drugs in 2016" and the number of other companies that had been interested in buying Medivation. The rise in Incyte's stock price after the Medivation acquisition was announced confirmed the court's materiality analysis. In addition, the court's summary of the factual allegations noted that Panuwat had reviewed Medivation's investment bankers' presentations, which had "discussed Medivation's peer companies in the biopharmaceutical industry, including Incyte," and that Panuwat himself had "noted to the investment bankers that they might want to consider Incyte a comparable company to Medivation."

Breach of Duty

The court next held that the SEC had sufficiently alleged a breach of Panuwat's fiduciary duties to Medivation under the misappropriation theory of liability: he had used MNPI obtained from his employer for his personal benefit in violation of an agreement not to do so. Panuwat had signed Medivation's insider-trading policy, which stated that signatories "may be in a position to profit financially by buying or selling or in some other way dealing in the Company's securities . . . *or the securities of another publicly traded company*, including all significant collaborators, customers, partners, supplies, or competitors of the Company. . . . For anyone to use such information to gain personal benefit . . . is illegal." (Emphasis added.)

In light of this broad prohibition, the court held that "the plain language of the policy covers 'the securities of another publicly trading company, *including*' the enumerated categories. . . . The word ['including'] does not cabin the policy's applicability to only the types of companies listed. . . . Because Incyte is a publicly traded company, it is covered by Medivation's trading policy."

Scienter

In evaluating whether the SEC had adequately pled Panuwat's scienter, the court noted disagreement among District Courts in the Ninth Circuit regarding whether a defendant must actually *use* the MNPI in carrying out a trade or whether he or she need only be *aware* of it. The court held that the Ninth Circuit's decision in *United States v. Smith*, 155 F.3d 1051 (9th Cir. 1998), which had required actual use, did not resolve the issue, because *Smith* was a criminal case, it had expressly left open the question whether the use standard was required in civil proceedings such as this one, and it had been decided before the SEC's promulgation of Rule 10b5-1, which requires only an awareness, not actual use, of MNPI.

Nevertheless, the court held that the SEC's allegations satisfied even the stricter actual-use standard. The SEC had pled several examples of circumstantial evidence showing actual use, including that Panuwat had bought Incyte options "within minutes" of learning that the Medivation deal was imminent and that he had never previously traded Incyte stock. The awareness standard was also satisfied, as the complaint included detailed allegations that Panuwat had been aware of the impending acquisition before he bought the Incyte options.

Acceptance of "Shadow Trading" as a Viable Theory of Liability

The court rejected Panuwat's due-process argument and, in so doing, signaled its acceptance of "shadow trading" as encompassed within the misappropriation theory of insider trading.

Panuwat argued that his due-process rights had been violated because the SEC's novel theory of "shadow trading" stretched the misappropriation theory beyond its previously recognized boundaries. The court conceded that "there appear to be no other cases where the [MNPI] at issue involved a third party." But, in the court's view, the "shadow trading" theory still fell within the framework of the misappropriation theory, which, by its own terms, reaches trading by corporate outsiders and can involve information that is material to more than one company. The theory also fit within what the court called Section 10(b)'s "expansive" language. The court concluded that "scienter and materiality provide sufficient guardrails to insider trading liability" even where the particular theory of liability has not previously been adjudicated.

Implications

The court's decision appears to validate the SEC's reliance on a "shadow trading" theory where a trader breaches his or her duty by using MNPI about one company to trade another company's securities. But the decision was based on the pleadings and depended on the specific factual allegations at issue, including that (*i*) the third-party issuer (Incyte) was one of only "a limited number" of companies in the acquisition target's business and financial space, (*ii*) the MNPI had specifically identified the third-party issuer as a comparable company, (*iii*) the trader had signed a confidentiality agreement that expressly prohibited trading the securities of *any* public company based on MNPI learned from his or her employer, and (*iv*) the trader had been directly involved in the underlying corporate discussions and presentations concerning the employer's acquisition. Changing these variables could conceivably produce different results. And the fact-intensive nature of these allegations increased the difficulty of obtaining a dismissal at the pleading stage.

For example, at what point does "a limited number" of comparable companies become too big a number for information about Company A to be material to Company B (or C, D, or E)? How comparable do Companies A and B need to be? Would the court have reached a different conclusion if the Medivation investment bankers' presentations had *not* mentioned Incyte as a comparable company, or if Panuwat had *not* seen those materials? What if the insider-trading policy had not *expressly* covered "the securities of another publicly traded company"? Would the lack of such language have proven fatal to the SEC's claims? Could the SEC have invoked general corporate fiduciary-duty principles prohibiting an insider from using corporate MNPI for his or her personal benefit? These and other issues might arise in future cases.

As we noted in our earlier report on this case, companies and traders, including private funds, should consider whether insider-trading policies and procedures, as well as any relevant nondisclosure agreements, cover securities of third-party companies. The language and breadth of those policies could be determinative – and could influence any trading restrictions or "walls" that companies implement.

Future cases might also explore the legal issue that the court did not decide in *Panuwat*: whether mere awareness of MNPI suffices to demonstrate scienter (as SEC Rule 10b5-1 says), or whether actual use is required. Courts have taken different positions on that issue.

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