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SEC Wins Insider-Trading Suit Alleging “Shadow Trading”

Corporate Defense and Disputes on **April 6, 2024**

A federal jury in California agreed with the SEC that a corporate official engaged in insider trading when he purchased securities of a company based on material nonpublic information (“MNPI”) about a different company. The April 5, 2024 verdict for the SEC in *SEC v. Panuwat* (N.D. Cal.) could embolden the SEC to pursue more claims of “shadow trading,” which involves trading the securities of a public company that is not the direct subject of the MNPI but whose stock price allegedly would be affected by that news.

The *Panuwat* case, which survived motions to dismiss and for summary judgment and has now produced a verdict in favor of the SEC, does not appear to break new ground under the misappropriation theory of insider trading in light of the particular facts presented. But the “shadow trading” theory focuses heightened attention on the types of nonpublic information that might be deemed material and on the duties that can exist by virtue of policies, agreements, contracts, and employment relationships.

Factual Background

The SEC brought its insider trading case against Matthew Panuwat, the then-head of business development at a biopharmaceutical company called Medivation. The SEC alleged that Panuwat had learned that Medivation was about to be acquired by a very large pharmaceutical firm and that, seven minutes after receiving an email from Medivation’s CEO reporting that the potential acquiror was ready to sign a deal that weekend, Panuwat had purchased call options on securities issued by Incyte, another biopharmaceutical company that allegedly shared Medivation’s general market space but was not a competitor.

The SEC contended 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 (oncology), that Incyte would become more attractive to potential acquirors once the Medivation deal was announced, and that Incyte's stock price would rise as a result. The market facts appeared to support the SEC's theory: when the Medivation acquisition was announced, Incyte's stock price rose 7.7%, and Panuwat made more than $100,000 on his call options.

The court denied Panuwat's pretrial motions to dismiss and for summary judgment. In ruling on those motions (especially the summary judgment motion), the court held that:

- The SEC had sufficiently established a factual dispute about whether information about the impending Medivation acquisition was material to Incyte.
- The SEC also had established that the information in the Medivation CEO's email was "nonpublic and available to Panuwat because of his position with Medivation." Panuwat had known (*i*) the identities of the companies that had submitted bids to buy Medivation, (*ii*) the amount of those bids, and (*iii*) that the bidding process "was pushing up the sale price." He also had known that the ultimate buyer wanted to announce a final deal on August 22, and he had known on August 18 (minutes before he bought his call options) "the expected timing and price point of the deal." While the market had been *generally* aware of the sale process, it had not known "the *final details* of the transaction – the final buyer, the final price, and the ultimate timing of the execution of the merger."
- A factual dispute existed as to whether Panuwat had read his CEO's email reporting that the buyer was ready to sign a deal.
- The SEC had sufficiently adduced evidence – under three independent theories – that Panuwat had breached "some fiduciary, contractual, or similar obligation" to Medivation when he bought the Incyte call options:
- Medivation's Insider Trading Policy prohibited employees from trading "the securities of *another publicly traded company*, including all significant collaborators, customers, partners, suppliers or competitors," based on inside information obtained through employment at Medivation (emphasis added);
- Panuwat had signed a Confidentiality Agreement that required him not to use Medivation's confidential information for his personal benefit; and
- A jury could find that Panuwat had breached "a duty of trust and confidence that was created when his employer, Medivation, entrusted him with confidential information." That alleged breach of duty did not depend on either the Insider

Trading Policy or the Confidentiality Agreement; it arose from common-law agency principles, which Panuwat could be deemed to have breached when he used for his personal benefit certain confidential information entrusted to him by his employer "without disclosing that fact to Medivation."

The Trial

The jury trial lasted eight days and included evidence showing that:

- Medivation and Incyte were both oncology companies but were not competitors or business partners.
- The market had been generally aware of Medivation's sale process and its progress but had not known proposed sale prices or the exact timing of interested parties' bids.
- Analysts had discussed the potential impact that Medivation's acquisition could have on other biopharmaceutical companies, including Incyte.
- Panuwat had been involved in the search for an appropriate buyer for Medivation and in the analysis of the potential impact of a sale.
- The sale process was confidential within Medivation, with code names assigned to all involved parties.
- The materials prepared by Medivation's investment banker had analyzed Medivation's position relative to that of other biopharmaceutical companies, including Incyte, and Panuwat had received those materials. The information about the other companies on the banker's list had been publicly available.
- The banker testified that the list of other companies "was our best attempt to define peer group because there weren't direct comparables. . . . This is not an industry like Coke and Pepsi where they're directly comparable and they compete for one another's dollar."
- On August 18, 2016, Medivation's CEO sent an email to Panuwat and twelve other employees stating that the ultimate buyer had "reiterated [to him] how much they really want this" transaction "this weekend," and naming a specific price for the deal.
- Seven minutes later, Panuwat started buying out-of-the-money Incyte call options at three different strike prices, each of which represented 81%, 70%, and 84% of the daily volume of those options sold in the market.
- Those purchases cost Panuwat $117,000 – approximately half his annual salary.

- The Medivation acquisition was announced four days later, on August 22, and Incyte's stock price rose that day by 7.7%.
- An SEC economist testified that, "when one company in an industry announces a merger, other companies in the industry typically have a positive stock price reaction to that." The witness said she had analyzed Incyte's stock-price movement on the day the Medivation acquisition was announced and had found that "it was not caused by normal fluctuations, it was too big for that."
- Two days after the Medivation acquisition was announced, Panuwat started selling his Incyte securities for $240,000, earning a profit of approximately $123,000.
- Panuwat testified that he likely would have made exactly the same trades at exactly the same time even if he had not received the CEO's email about the impending acquisition. He said he had become interested in investing in Incyte because of a Goldman Sachs report in July 2016 recommending the purchase of Incyte call options before the company issued its earnings report on August 9 (nine days before Panuwat bought the options). Panuwat had not invested before the earnings announcement, but he testified that he had read the earnings report, which he considered "quite favorable," and had watched the stock price decline in subsequent days.
- Panuwat testified that he had invested $117,000 – the largest trade he had ever made until that time – because, earlier in the year, he had earned money on other trades and wanted to reinvest to minimize taxes on those trading gains.
- Panuwat conceded that he had not previously told SEC investigators about the Goldman Sachs recommendation or his tax strategy as the asserted reasons for buying the call options. And he had testified in a deposition that he did not remember why he had decided to trade Incyte securities in August 2016: "I don't recall there being a specific event around that time."
- Panuwat testified at trial that he had not thought even "for one second" that his trading violated the securities laws.

The Jury Verdict

The jury was required to determine whether Panuwat had owed a duty of "trust, confidence or confidentiality" to Medivation and whether, as a result of his employment, he had possessed nonpublic information that was material to Incyte. The jury also needed to assess whether Panuwat had purchased the Incyte call options on the basis of that nonpublic information and whether he had "acted recklessly" in doing so.

The jury deliberated a little more than two hours and rendered a verdict in favor of the SEC. We would expect to see an appeal and, perhaps, post-verdict motions. Stay tuned.

Implications

The jury's verdict, like the prior court rulings in favor of the SEC, 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. The SEC might now be encouraged to pursue more such cases because the SEC appears to believe – and certain academic literature has suggested – that "shadow trading" occurs with some frequency.

The *Panuwat* verdict, like the prior court decisions, seems to have been fact-specific. For example, the jury's materiality analysis presumably considered evidence showing 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*) analysts had specifically cited the third party as a company that could be affected by the acquisition target's transaction; (*iii*) the acquisition target's investment banker had included the third party in the banker's transaction analysis; and (*iv*) the trader had been directly involved in the underlying confidential corporate discussions and presentations concerning his employer's sale. In addition, the SEC's witnesses testified that the third party's stock price was likely to be, and in fact was, positively affected by news of the Medivation acquisition. Changing any of those variables might have produced a different result.

But even though the specific facts presumably mattered to the jury, the *Panuwat* case cautions against taking too narrow a view of whether nonpublic information might be material – especially when materiality will be assessed in hindsight, and likely after the trader has profited from or avoided a loss on a transaction. *Panuwat* should encourage prospective traders to take a broader view of materiality and to consider the extent to which MNPI about one company might be material to a second company, even if the second company is not a direct competitor or business partner of the first one. Prospective traders might want to consider broader market contexts, such as the identities of competitors or alternatives, or, as in this case, the number of companies in a particular market sector (here, "mid-cap" oncology companies).

The *Panuwat* case should also cause prospective traders to think about the scope of any duties that might apply to them – and that they therefore might breach if they trade on MNPI. The court here concluded in its summary judgment ruling that three independent duties could apply to Panuwat: (*i*) his duties under Medivation's Insider Trading Policy, which prohibited trading "the securities of another publicly-traded company" based on MNPI obtained through his Medivation employment, (*ii*) his duties under Medivation's Confidentiality Agreement, and (*iii*) his common-law employment duties, which imposed "a duty of trust and confidence" on him when he was entrusted with confidential information, and which prohibited him from using that information for his personal benefit "without disclosing that fact to" his employer.

The employment-related duties likely will not apply to nonemployee traders, such as companies, private funds, or other organizations. If such an entity uses *its own* MNPI for *its own* benefit, it would not be subject to the employment-related duty that bound Panuwat when he used his employer's MNPI for his personal benefit.

But companies or funds could have *contractual* duties to the source of the MNPI, and those agreements could limit the use of MNPI obtained pursuant to those agreements. A company or fund thus could conceivably be viewed as engaging in "shadow trading" under the misappropriation theory if it trades a third-party company's securities while subject to an agreement that specifically prohibits trading the securities of other companies. A "shadow trading" issue might arise even under an agreement that more broadly prohibits the use of MNPI for *any* purpose other than that of the agreement.

Companies and traders, including private funds, therefore should carefully consider the terms of insider-trading policies and procedures, as well as any relevant contracts and nondisclosure agreements, to determine whether any of those materials cover securities of third-party issuers or place any other limitations on the use of MNPI obtained under those policies or agreements. The reach of those policies and agreements could be determinative and could influence any trading restrictions or "walls" that companies implement.

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