Financial Regulatory Alert

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New "Shadow Insider Trading" SEC Enforcement Action -- Four Lessons for Private Fund Managers

August 23, 2021

Key Points

- Last week, the U.S. Securities and Exchange Commission filed a complaint in federal court in California premised on the novel legal theory that the insider trading laws apply where an insider uses confidential information regarding the business of one company to trade in the securities of another issuer, which is alleged to be correlated in some way, such as a peer company in the same relatively small industry.
- The SEC faces obstacles in establishing the illegality of such conduct at trial, which some have given the moniker "shadow trading."
- Private fund managers should track this case, as it may have broader implications, particularly for advisers that are active investors in sectors where the SEC may allege issuers are closely correlated to one another from a trading perspective.

The SEC has a long history of adopting novel theories in litigation to convince the courts to expand the scope of the federal insider trading laws. The SEC's latest effort comes in an August 17, 2021 complaint (*SEC v. Panuwat*[1]) filed against a biopharmaceutical executive for a practice that is colloquially known as "shadow trading." "Shadow trading" involves buying or selling the securities of one company while in possession of confidential information of another closely correlated or "economically-linked" company. The *Panuwat* complaint is the first instance of the SEC litigating a shadow insider trading case.

The SEC's complaint alleges that Matthew Panuwat, formerly a business development executive at Medivation Inc., misappropriated confidential information that he obtained in the course of his employment at Medivation that it was the target of an acquisition by Pfizer. Panuwat, however, did not purchase Medivation securities – he purchased short-term options in Incyte Corporation, a competitor "whose value he anticipated would materially increase when the Medivation acquisition announcement became public."

The SEC alleged that the defendant: (1) was aware that both companies' stock prices had recently increased in response to an acquisition of a third peer company in the

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same space, (2) had discussed the fact that Medivation and Incyte were closely comparable companies with bankers working on the deal, and (3) was aware that large pharma companies were interested in acquiring mid-cap oncology companies and, when the Medivation transaction was made public, Incyte would be one of the few remaining available candidates for future transactions in the space. The SEC also highlighted that, after the Medivation transaction became public, Incyte's stock price increased by 8%.

These allegations provide a roadmap for how the SEC will seek to establish materiality, which will no doubt be a hotly contested issue in litigation. In doing so, the SEC will likely seek to capitalize on the broad and sometimes murky *Basic v. Levinson* definition that the courts have adopted for materiality – i.e., whether there is a substantial likelihood that a reasonable investor would view the information as having significantly altered the "total mix" of information that would be significant to a decision to trade the relevant securities. In the end, the question of whether the two companies were sufficiently correlated to for the SEC to establish materiality will be require a fact intensive analysis in this or any "shadow insider trading" case. While the SEC appears to have concluded that it has sufficient evidence to proceed here, where the agency will line draw the line when evaluating future potential enforcement actions – or whether a court or a jury will agree with the SEC's position in the *Panuwat* case – remains to be seen.

The SEC also appears to be anticipating that the defendant will argue that his Incyte trades did not breach a duty of trust or confidence to his employer, another essential element of insider trading under the misappropriation theory set forth in the *O'Hagan* line of cases. In the complaint, the SEC has alleged that Medivation's internal policies should be read to have prohibited Panuwat from personally profiting *in any way* from material nonpublic information concerning Medivation. In staking out this position, the SEC relied heavily on language in Medivation's insider trading policy that barred the defendant from profiting through trading in "the securities of another publicly traded company, including all significant collaborators, customers, partners, suppliers, or competitors of [Medivation]." According to the SEC, the defendant therefore violated a duty of trust and confidence he owed to Medivation, even though the trading did not involve Medivation securities. Whether a court or jury will agree that the policy at issue is sufficient to establish a legal duty of trust or confidence under these circumstances also remains to be seen.

Finally, the SEC must show that Mr. Panuwat had the requisite "scienter," or intent to deceive, manipulate or defraud, which is required to establish an insider trading violation under SEC Rule 10b-5. This will raise questions about whether Mr. Panawut was put on sufficient notice that he was violating a duty or was otherwise engaging in misconduct by trading Incyte options. Because the enforcement action against Panuwat is civil in nature, the SEC will likely argue that it does not need to prove actual intent and can establish scienter through evidence of reckless conduct.

Implications

The *Panuwat* case makes clear that the SEC now views so-called "shadow trading" as another potential arrow in its enforcement quiver. Unless the SEC loses this litigation on the merits, whether through summary judgment or at the end of a trial, it could be emboldened to pursue similar actions in the future, particularly in the private funds space. The SEC's Division of Examinations may also be on the lookout for potential

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instances of "shadow trading" when conducting examinations of investment advisers who actively trade in relatively small sectors or subsectors with a limited number of players that could be viewed as "economically-linked."

The term "shadow trading", which is not explicitly used in the SEC's complaint, appears to have been coined in an academic study claiming that behavior indicative of this type of trading is on the rise.[2] While it is too early to tell just how aggressively the SEC will pursue allegations of "shadow trading" in future matters, there have been prior instances, such as in the case of options backdating, where similar academic studies have triggered new waves of enforcement activity.

Even before *Panuwat*, we have seen the Examination Staff inquire about whether an adviser's policies and procedures address the perceived risk that an adviser could obtain material non-public information about public issuers from private portfolio companies or other channels.

For all of these reasons, legal and compliance professionals at private fund managers should pay close attention to the *Panuwat* litigation. In the meantime, however, they should consider steps such as the following:

- **Enhanced, Targeted, Interactive Training**. Panuwat could potentially represent a significant expansion of insider trading liability, and any response to that threat affirmatively requires the participation of investment professionals. Legal and compliance professionals should consider interactive "teach-ins" with their analysts and portfolio managers to discuss this case and its implications, and to holistically identify any vectors of MNPI that could fit into a "shadow trading" fact pattern.
- **Risk Assessment**. Incorporating any front office feedback, legal and compliance departments should assess the degree to which shadow trading presents a practical risk to the firm's particular business model and investment strategy. Areas to focus on include situations where the firm receives confidential information from any companies (including formal non-disclosure agreements, as well situations where firm personnel serve as directors). This assessment should include exposure to information from or about private companies, as well publicly-listed firms.
- **Policy and Procedures Review**. Legal and compliance departments should then determine whether any revisions to the firm's insider trading policies, procedures or surveillance programs would be advisable based on the above review. They should consider how the SEC utilized a broad company policy in the *Panuwat* case before adopting any changes, while at the same time being mindful of the adviser's obligations under Section 204A of the Investment Advisers Act.[3] Given the novel nature of this theory, compliance personnel may want to consider supplementing traditional surveillance techniques with more interactive measures involving personnel receiving confidential information.

[1] SEC v. Panuwat, No. 4:21-cv-06322 (N.D. Cal. Aug. 17, 2021), available here; *SEC Charges Biopharmaceutical Company Employee with Insider Trading*, SEC Press Release No. 2021-155 (Aug. 17, 2021), available here.

[2] See Mihir N. Mehta et al., *Shadow Trading*, Acct. Rev. (Sept. 6, 2020), available here.

[3] Section 204A requires investment advisers to establish, maintain, and enforce written policies and procedures reasonably designed to prevent the misuse of material non-public information.

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