District Court Endorses SEC's 'Shadow Insider Trading' Theory – An Analysis of the Court's Decision and Its Potential Implications for Private Fund Managers

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As previously reported, in August 2021, the U.S. Securities and Exchange Commission filed a complaint in *SEC v. Panuwat*,[1] initiating the first enforcement action seeking to proscribe as prohibited insider trading the practice of so-called "shadow trading." In *Panuwat*, the SEC has staked out the novel position that the insider trading laws apply where an insider uses confidential information regarding the business of one issuer to trade in the securities of another issuer, such as a peer company in the same relatively small industry, whose stock price is alleged to be correlated with that of the issuer. In his first challenge to the SEC's charges, Panuwat filed a motion to dismiss the complaint, arguing that even if the allegations against him were assumed to be true, his conduct did not constitute insider trading. On January 14, 2022, the federal district court overseeing the *Panuwat* case denied the motion, holding that the SEC's allegations and legal theory provided a sufficient basis for the litigation to continue.

Panuwat has been closely followed because of its potential implications for private funds and other institutional investors, who commonly receive material non-public information. Before *Panuwat*, the typical playbook for a private fund manager in these situations involved compliance restricting the firm's trading in the securities of the issuer or issuers that were the subject of the material non-public information. For example, if the material non-public information involved a potential merger, a firm's compliance department would consider restricting the securities of the issuers involved in that transaction. *Panuwat*, however, raises new and thorny questions about whether and to what degree compliance officers may need to cast a wider net. While the recent *Panuwat* decision doesn't necessarily answer these questions, it does contain some hints as to steps private funds can consider to mitigate "shadow trading" risk.

Factual Background

The SEC sued Matthew Panuwat, a former senior director of business development at Medivation, an oncology-focused biopharmaceutical company, alleging that he

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engaged in insider trading based on his confidential knowledge that a larger pharmaceutical company would soon acquire Medivation. Panuwat, however, did not trade the securities of Medivation. Instead, Panuwat allegedly used the confidential information that he misappropriated from Medivation to trade in the securities of Incyte, a different oncology-focused biopharmaceutical company that had no involvement in the proposed merger. The SEC took the position that the information was nonetheless material to Incyte because Incyte and Medivation were among a small group of closely comparable companies in a sector that was the subject of a significant amount of acquisition interest. According to the SEC, Incyte's stock price could be expected to increase once the Medivation news was announced because the transaction would leave Incyte as one of the few remaining potential targets for companies interested in making similar acquisitions.

Panuwat's responsibilities at Medivation included closely tracking stock prices of other oncology-focused companies such as Incyte, and it was through this role that he received confidential information that Medivation would soon be acquired. Within minutes of receiving an email indicating that Medivation would be acquired, Panuwat purchased short dated out-of-the-money stock options of Incyte. Panuwat, who had never traded Incyte securities before, did not inform anyone at Medivation of this trade. In the following days, the acquisition was announced and Incyte's share price rose, resulting in profits of over $100,000 for Panuwat.

As an employee of Medivation, Panuwat agreed to abide by the company's insider trading policy, which contained language stating that he could not use the company's information to profit by trading in the securities of *any public company*, not just Medivation.

On August 17, 2021, the SEC charged Panuwat with insider trading in violation of Section 10(b) of the Securities Exchange Act of 1934 and Exchange Act Rule 10b-5. On November 1, 2021, Panuwat filed a motion to dismiss, and on January 14, 2022, the court denied his motion.

The Court's Denial of Panuwat's Motion to Dismiss

In his motion to dismiss, Panuwat argued that the SEC failed to adequately plead the following essential elements of an insider trading claim: materiality, breach of a duty, and scienter. The court rejected each of Panuwat's arguments.

Materiality

Panuwat argued that, as a matter of law, the information he possessed could not be material because it was not information *about* Incyte (*i.e.*, Incyte was not involved in the merger transaction and Panuwat had no material non-public information about Incyte's business operations). Panuwat further argued that, in circumstances where the information relates to a merger between two companies, the information can only be material to the securities of those two companies (in this case, Medivation and its acquirer).

The court rejected Panuwat's arguments based on the plain language of the applicable statute and regulations, Section 10(b) of the Exchange Act and Rule 10b-5, as well as the well-established principle that information is deemed material "if there is a substantial likelihood that its disclosure would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available."[2]

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The court found no support in the text of the statute or in case law for a categorical rule that merger information can only be material to the two companies involved in the transaction. Instead, the court reasoned that the materiality standard "only focuses on whether the information is significant 'to the issuer of the securities'" in which the defendant traded. The court then held that the SEC's allegations were sufficient to support a finding of materiality because: (1) Medivation and Incyte were among only a few closely comparable companies in a relatively small sector; (2) several companies had expressed an interest in acquiring Medivation before it decided to pursue this particular transaction; (3) it was reasonable to assume the companies that were unsuccessful in their attempts to acquire Medivation would turn their attention to Incyte as the next potential acquisition target; and (4) Incyte's stock price increased the day the Medivation merger news was announced.

Duty

In his motion to dismiss, Panuwat conceded that he owed a duty to Medivation. However, Panuwat argued that he did not breach this duty because Medivation's insider trading policy did not prohibit him from trading the securities of Incyte. The relevant language of the Medivation policy, which was also cited prominently in the SEC's complaint, reads as follows:

During the course of your employment you may receive important information that is not yet publically disseminated about the Company. Because of your access to this information, you 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 publically traded company, including all significant collaborators, customers, partners, suppliers, or competitors of the Company*. For anyone to use such information to gain personal benefit is illegal.[3]

Panuwat argued that the SEC's complaint could not support a finding that he breached his duties under the policy because there was no allegation that Incyte was a significant collaborator, customer, partner, supplier, or competitor of Medivation.

The court disagreed, focusing on the language that prohibited Medivation's employees from using the company's confidential information to profit by trading the securities of "another publicly traded company." The court found that this meant that the policy was broad enough to cover trading in the securities of *any* public company and that the subsequent language about significant collaborators, customers, partners, suppliers, or competitors merely provided a non-exhaustive list of examples of the types of companies that might be covered. Based on this interpretation, the court found that the SEC's allegations were sufficient to establish that Panuwat breached his duty to Medivation by using the information about the acquisition to trade Incyte's securities.

Scienter

Finally, Panuwat argued that the SEC failed to adequately plead scienter, the mental state required for insider trading, because the facts alleged could not support a finding that he actually used the Medivation acquisition information to trade Incyte securities.

The court recognized that there is a split among district courts in the Ninth Circuit as to whether the SEC must prove a defendant actually *used*, rather than merely possessed, material non-public information to support a charge of insider trading. However, the court rejected Panuwat's argument without resolving this issue because

it found that the SEC sufficiently alleged that he used the material non-public information to make his Incyte trades. The court found that Panuwat's use of the information could be inferred circumstantially based on the fact that he traded Incyte securities, for the first time ever, mere minutes after receiving an email indicating that the Medivation acquisition was imminent.

Takeaways

While the court's denial of Panuwat's motion to dismiss does not mean the SEC will ultimately be able to prove its case, it is nonetheless a meaningful victory for the agency. Although the *Panuwat* decision would not be binding precedent in other cases, the SEC can be expected to cite it in future "shadow trading" enforcement actions in an effort to persuade other courts to adopt its analysis. In our prior client alert on this topic, we identified several steps, which we continue to recommend private fund managers consider taking in response to the *Panuwat* case. Below is some additional guidance based on the court's recent decision:

- **"Shadow Trading" Should Continue to be a Part of the Compliance Agenda**. The *Panuwat* court flatly rejected the argument that information about a company is not material unless it pertains directly to *that* company's operations, business, or transaction plans. Legal and Compliance professionals should keep this in mind when determining which issuers to add to their firms' restricted lists. While Panuwat has not changed the definition of materiality, it highlights the perils of adopting an overly narrow and formalistic approach, especially in situations involving small sectors of the market with a limited number of issuers. Firms should also consider covering the issues raised by the *Panuwat* case in compliance trainings for investment professionals.
- **The Specific Language in Confidentiality Agreements and Insider Trading Policies Matters**. One of the most interesting aspects of the recent *Panuwat* opinion was the court's intense focus on the language of Medivation's insider trading policy. While it is unclear whether the court would have found a duty breach if Medivation's insider trading policy had not specifically prohibited trading in the securities of "another public company," this language was obviously important to both the court and the SEC. Firms should consider "shadow trading" risks when reviewing the specific language of internal trading policies, confidentiality agreements, wall-crossing requests, and other similar documents. In addition, before a firm permits an employee to join a company's board of directors, compliance should consider reviewing the language of that company's insider trading policy. As the *Panuwat* case shows, overly broad or unclear language in these sorts of documents can potentially broaden the scope of the duty and applicable theories of liability.

Panuwat's motion to dismiss was his first procedural opportunity to challenge the SEC's case. The court's decision to deny the motion does not resolve the case in the SEC's favor and the litigation is still ongoing. It is also important to note that, for the purposes of deciding the motion to dismiss, the court was required to assume all of the allegations in the SEC's complaint were true. The case will now move into discovery, after which Panuwat will have another opportunity to seek dismissal by filing for summary judgement and, if that motion is not granted, defend the case at trial. *Panuwat* will therefore continue to be a case to watch for legal and compliance professionals in the private funds industry.

[1] No. 4:21-cv-06322 (N.D. Cal. Aug. 17, 2021).

[2] *SEC v. Panuwat*, No. 4:21-cv-06322 (N.D. Cal. Aug. 17, 2021), Mot. to Dismiss Order, filed January 14, 2022, at 5, *citing Basic Inc. v. Levinson*, 485, U.S. 224, 231-2 (1988).

[3] *Id*. at 1-2 (cleaned up) (emphasis added).

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