

The SEC Secures Major Trial Victory in Its First ‘Shadow Trading’ Insider Trading Enforcement Action

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On April 5th, a California federal jury found a former Medivation executive liable for insider trading under the novel liability theory of “shadow trading,” following an eight-day trial and less than three hours of deliberation.¹ The theory of shadow trading is derived from the well-accepted misappropriation theory of insider trading liability but occurs when a corporate insider uses material, nonpublic information about one company (in whose securities the insider does not trade) to trade in the stock of a similarly situated company with a sufficient market connection such that the nonpublic information is determined to be material to the trade executed.

Although, following the verdict, SEC Enforcement Director Gurbir Grewal stressed his view that there was “nothing novel” about the case, which was insider trading “pure and simple,”² this is the first time the SEC has alleged insider trading liability based on the shadow trading theory. The district court, in a pretrial motion in limine ruling, agreed with the SEC that the case was not novel or highly unusual by deciding that the defense could not argue at trial that the SEC’s case was “highly unusual,” “unique,” “novel,” “unanticipated,” “unexpected” or “brought without fair notice.”³

The SEC alleged that Matthew Panuwat purchased stock options in a rival company, Incyte, because he believed that the public announcement of Medivation’s acquisition by Pfizer would also cause Incyte’s stock price to rise and would make Incyte a more attractive target for acquisition.⁴ According to the complaint, Panuwat allegedly purchased call options in Incyte, a midsize biopharmaceutical company focused on late-stage oncology treatments, seven

minutes after receiving the confidential information that Pfizer would acquire Medivation, the midsize, oncology-focused biopharmaceutical company where he served as head of business development.⁵ Panuwat’s purchase of call options cost \$116,905,⁶ approximately half of his annual salary.

Within a few days of Pfizer’s announcement of the acquisition of Medivation, Incyte’s stock increased 7.7 percent, allowing Mr. Panuwat to make approximately \$120,000⁷ from his well-timed call option investment. The complaint further alleged that Medivation’s insider trading policy expressly forbade employees from using confidential information acquired at Medivation to trade in securities of any other publicly traded company.⁸ In addition, Panuwat had signed a confidentiality agreement that did not allow him to use Medivation’s confidential information for his personal benefit.⁹

Although Panuwat moved to dismiss the SEC’s shadow trading action on several grounds, which he also pursued in a motion for summary judgment, the court denied these motions, ruling that the SEC’s action fell “within the general framework of insider trading, and the expansive language of” the federal securities laws.¹⁰

A key issue in pretrial litigation and at trial was whether the information Panuwat received was material to Incyte. Panuwat argued that the information was not material to his trades in Incyte because it was not information about Incyte, which was not a party to the planned transaction; there wasn’t actually a commercial connection between the two companies; and they were not competitors. However, the court concluded that the SEC had adequately alleged facts in its complaint to establish materiality and had shown at the summary judgment stage a sufficient market connection between Medivation and Incyte such that a jury could find that a

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reasonable investor would view the information Panuwat received as material to Incyte.¹¹

In coming to this conclusion, the court stressed the importance of the level of market connection between the two companies to the materiality analysis. In addition, the court relied on the following factors as evidence of the market connection between Medivation and Incyte: both companies operated in an industry where there were a small number of viable acquisition candidates; analyst reports and financial news articles reported at the time that acquisition interest in Medivation showed Incyte's attractiveness to investors; evidence put on by the SEC demonstrated that Medivation's investment bankers viewed the two companies as comparable peer companies; and, ultimately, that Incyte's stock price did in fact rise 7.7 percent after the Medivation deal was announced.¹²

In his defense, Panuwat offered evidence that Medivation and Incyte are not actually competitors and thus do not have a sufficient market connection under the shadow trading theory. For instance, Medivation did not list Incyte as a competitor in its own public reports. During his testimony, Panuwat told jurors that he did not believe that trading in Incyte's stock violated securities laws and that he did not base his decision to buy the options on confidential information regarding the acquisition of Medivation.¹³ He also testified that at the time he purchased the call options, it was public knowledge that there were multiple potential bidders for Medivation.¹⁴

Prior to deliberations, U.S. District Judge William H. Orrick instructed the jury on the elements that the SEC had to prove, by a preponderance of the evidence, in order to establish liability. The jury had to find that: (1) Panuwat owed a duty of "trust, confidence or confidentiality" to Medivation; (2) as a result of his employment, he had nonpublic information that was material to Incyte; (3) Panuwat bought the Incyte call options on the basis of that information and in a breach of his duty to Medivation; and (4) he knew that the information was

confidential and material, and knew or "acted recklessly" as to whether he had Medivation's consent to trade on it.¹⁵ Notably, the jury deliberated for just over two hours before finding Panuwat liable for insider trading. Of course, Panuwat may appeal.

Conclusion

This case represents a notable expansion in insider trading enforcement efforts by the SEC. Whether the SEC labels shadow trading cases novel or not, market participants, SEC issuers and regulated entities must carefully consider the SEC's now court and jury approved expansive view of insider trading. With this victory in hand, the SEC will likely pursue other shadow trading cases, particularly if, as certain academic literature has suggested, shadow trading is not an isolated occurrence.

It is also possible that criminal authorities will investigate shadow trading allegations, though a higher burden of proof may impact the pursuit of such prosecutions. Clearly, market participants should take great care to avoid adopting an overly narrow view of what might constitute material nonpublic information, particularly given that the SEC and a jury will assess materiality with the benefit of hindsight after a trader has either profited from a successful transaction or avoided a significant loss.

Panuwat should also prompt all public companies – and in particular, investment advisors and broker-dealers, who are required to adopt and implement policies and procedures reasonably designed to prevent the misuse of material nonpublic information – to carefully reevaluate their insider trading policies and controls regarding confidential information and consider improvements. In addition, companies should assess whether enhancements need to be made to the insider trading compliance training provided to employees, executives and board members to reflect the SEC's expansive views on the scope of the law against insider trading and also any new policy changes implemented.

Notes

1. <https://www.sec.gov/news/statement/grewal-statement-040524>.
2. *Statement of Jury's Verdict in Trial of Matthew Panuwat*, Gurbir S. Grewal (Director, SEC Division of Enforcement) (April 5, 2024), <https://www.sec.gov/news/statement/grewal-statement-040524>.
3. Pretrial Order Ruling on Motions in Limine at 15, *Securities and Exchange Commission v. Panuwat* (2024).
4. <https://www.sec.gov/litigation/litreleases/lr-25170>.
5. <https://www.sec.gov/litigation/litreleases/lr-25170>.
6. Order Denying Defendant's Motion for Summary Judgment at 4, *Securities and Exchange Commission v. Panuwat* (2024) (No. 85).
7. Order Denying Defendant's Motion for Summary Judgment at 5, *Securities and Exchange Commission v. Panuwat* (2024) (No. 85).
8. *Id.*
9. *Id.*
10. Order Denying Motion to Dismiss at 12, *Securities and Exchange Commission v. Panuwat* (2024) (No. 26).
11. Order Denying Defendant's Motion for Summary Judgment at 8-11, *Securities and Exchange Commission v. Panuwat* (2024) (No. 85).
12. <https://www.jdsupra.com/legalnews/sec-v-panuwat-the-sec-s-novel-shadow-6632411>.
13. <https://www.law360.com/corporate/articles/1822388/jury-finds-pharma-exec-shadow-traded-with-inside-info>.
14. <https://www.law360.com/corporate/articles/1818844/accused-shadow-trader-can-t-recall-why-he-bought-stock>.
15. Final (Proposed) Jury Instructions at 17, *Securities and Exchange Commission v. Panuwat* (2024) (No. 155).