

Alert

SEC Charges Novel Insider Trading Case and Shines a Spotlight on ‘Shadow Trading’

August 19, 2021

On Aug. 17, 2021, the U.S. Securities and Exchange Commission (“SEC”) filed a complaint against a former corporate executive for “shadow trading,” a form of insider trading where a person uses confidential information about one company to trade in the securities of an “economically linked” company, such as a competitor in the same industry.¹ As further detailed below, the SEC alleged that moments after learning his company was being acquired, a corporate executive purchased the securities of a competing company based on the belief that the competitor’s stock price would rise following the public announcement of the merger.

While the charges appear to be grounded in existing law, the SEC has never brought a case like this. The defendant is contesting the charges which should create an opportunity for a court to provide clarity as to whether awareness of material, nonpublic information (“MNPI”) about one company precludes trading in an unaffiliated company. In the interim, this enforcement action reveals a new way in which the SEC intends to apply insider trading concepts — one which likely will have significant implications for the entire investment community.

Background

The SEC complaint alleges that “within minutes” of learning that Medivation Inc. (“Medivation”) would be acquired by Pfizer Inc., Matthew Panuwat, a senior business development executive at Medivation, purchased out-of-the-money, short-term call options in Medivation’s competitor, Incyte Corporation (“Incyte”).² The stock options purchased by Panuwat roughly doubled in value following announcement of the Medivation acquisition, resulting in profits of \$107,066.³ The complaint notes that Panuwat had never before traded in the stock or options of Incyte.⁴

The SEC’s complaint describes in detail the correlation between the confidential information about the pending acquisition of Medivation and the anticipated positive impact on the stock price of its competitor, Incyte, alleging that Panuwat knew, or was reckless in not knowing, that the information concerning Medivation’s imminent acquisition was not only material to Medivation, but also to Incyte.⁵

¹ Complaint, *SEC v. Panuwat*, No. 4:21-cv-06322 (N.D. Cal. filed Aug. 17, 2021), ECF No. 1, available [here](#); *SEC Charges Biopharmaceutical Company Employee with Insider Trading*, SEC Press Release No. 2021-155 (Aug. 17, 2021), available [here](#); see also Mihir N. Mehta et al., *Shadow Trading*, ACCT. REV., July 2021, at 367, manuscript available [here](#).

² Complaint at 8, *SEC v. Panuwat*, No. 4:21-cv-06322 (N.D. Cal. filed Aug. 17, 2021), ECF No. 1.

³ *Id.* at 8–9.

⁴ *Id.* at 8.

⁵ *Id.* at 7.

Specifically, in advance of the announcement, Panuwat reviewed presentations from Medivation’s investment bankers concluding that Medivation and Incyte were similarly situated firms.⁶ The complaint notes that Panuwat closely tracked both Incyte and Medivation’s stock prices and knew that a prior M&A announcement by a peer firm the previous year had resulted in material increases to both Incyte’s and Medivation’s stock prices, and therefore Panuwat appreciated the impact that the takeover announcement would have on the competitor’s stock price.⁷ The complaint also portrays Panuwat as a sophisticated market participant, in that he had worked in the biopharmaceutical industry for fifteen years, including eight years in the global healthcare investment banking division of a top investment bank.⁸

As a Medivation employee, the SEC maintains that Panuwat owed Medivation a duty of trust and confidence, including a duty to refrain from using Medivation’s proprietary information for personal gain.⁹ In its complaint, the SEC quoted Medivation’s insider trading policy which expressly forbade Panuwat from using Medivation’s confidential information to trade in the securities of any other publicly traded company.¹⁰ Panuwat also did not seek pre-clearance or authorization from Medivation for his options trades and did not inform anyone at Medivation about them after the fact.¹¹

The SEC’s action alleges violations by Panuwat of the anti-fraud provisions of the Securities Exchange Act of 1934, and seeks injunctive relief, civil penalties and a bar from serving as an officer or director of a public company.¹²

Insider Trading and Shadow Trading

Under the classical theory of insider trading, a corporate insider violates section 10(b) and Rule 10b-5 by trading in the securities of their own company on the basis of MNPI. The misappropriation theory, by contrast, prohibits corporate outsiders from trading based on MNPI obtained in breach of a duty owed to the source of the information. While the misappropriation theory was controversial when first advanced by the government, it has become well-established by the courts.¹³

The legality of shadow trading in any particular instance will turn on the question of materiality and the specific facts and circumstances related to the information and the companies at issue, including the scope of the duty owed by the insider to the company. In particular, the SEC will need to establish whether the MNPI was material to the company whose securities were traded. In this case, the specific facts are critical to understand why the SEC brought this action. The complaint emphasizes that the investment banks advising Medivation “drew close parallels between Medivation and Incyte, including

⁶ *Id.* at 5.

⁷ *Id.* at 5–6.

⁸ *Id.* at 3.

⁹ *Id.* at 2, 8.

¹⁰ The policy stated: “During the course of your employment ... you may receive important information that is not yet publicly 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 publicly traded company*, including all ... competitors of the Company. ... For anyone to use such information to gain personal benefit ... is illegal. ...” *Id.* at 5 (emphasis added).

¹¹ *Id.*

¹² *Id.* at 10.

¹³ See *United States v. O’Hagan*, 521 U.S. 642, 651–53 (1997).

that both were valuable, mid-cap, oncology-focused companies with a profitable FDA-approved (commercial stage) drug on the U.S. market.”¹⁴ The SEC also highlighted that Panuwat knew Medivation and Incyte securities traded similarly following a previous merger in the sector and that, although he had never traded Incyte securities previously, Panuwat did so within minutes of learning about the confidential information.¹⁵

Implications

The implications of this case, particularly for private investment funds, are significant. The SEC has staked out new ground that all market professionals should take into consideration and that will continue to define the scope of insider trading in the coming years.

As with any case of first impression, the SEC has not provided any specific guidance as to what it will consider shadow trading, nor has it defined what it considers economically linked companies. Legal and compliance professionals at private investment funds should pay particular attention to this matter and its impact to their compliance programs, and should consider whether it may be appropriate to update relevant policies and procedures and to provide targeted training. When evaluating whether to restrict trading in a security upon the receipt of MNPI, even if inadvertent, such an analysis should include a determination of whether to restrict trading in “economically linked” companies.

SRZ anticipates hosting a subsequent event aimed at exploring the implications of this newly filed enforcement proceeding and its impact on the investment community. Please watch for follow-up correspondence as we finalize the details of this important discussion.

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If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or one of the authors.

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¹⁴ Complaint at 5, *SEC v. Panuwat*, No. 4:21-cv-06322 (N.D. Cal. filed Aug. 17, 2021), ECF No. 1.

¹⁵ *Id.* at 2, 6, 8.

¹⁶ This *Alert* was prepared with the assistance of Derek N. Lacarrubba, Kolby K. Loft and J. Eric Prather.