COURT APPROVES SEC'S NOVEL "SHADOW TRADING" THEORY

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On January 14, 2022, the Honorable William H. Orrick of the Northern District of California permitted a Securities and Exchange Commission's ("SEC") complaint asserting a novel application of the "misappropriation theory" of insider trading liability to proceed to discovery. The SEC's complaint alleges that Matthew Panuwat, formerly an executive at Medivation Inc. ("Medivation"), a mid-cap oncology-focused biopharmaceutical company, engaged in so-called "shadow trading" by using confidential information about a planned acquisition of Medivation to trade in the securities of a peer pharmaceutical company. [1]

In the typical application of the "misappropriation theory" of insider trading, a corporate insider violates Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 by "misappropriating" confidential, material, and nonpublic information obtained from his or her own company to trade in the securities of the insider's own company or the company's merger partner in breach of the insider's duty to his or her company. Here, however, Panuwat allegedly traded in the securities of a third company with no direct connection to his company or its merger partner, except for its presence in the mid-cap biopharmaceutical market.

According to the SEC, when Panuwat joined Medivation in 2014, he signed its insider trading policy, which forbade employees from profiting by trading Medivation's securities, "or the securities of another publicly-traded company, including all significant collaborators, customers, partners, suppliers, or competitors of the Company." As a senior director of business development, Panuwat participated in Medivation's exploration of potential mergers and worked closely with Medivation's top executives and investment bankers. On August 18, 2016, Panuwat received an email from Medivation's CEO describing Pfizer's intent to finalize details of its impending Medivation acquisition. Within minutes of receiving the email, Panuwat allegedly bought short-term stock options in Medivation's competitor, Incyte Corporation ("Incyte"), believing the market price of Incyte's securities would increase when the Medivation acquisition became public. When the acquisition was announced several days later, Medivation, Incyte, and peer biopharmaceutical companies' share prices increased significantly. The SEC alleges Panuwat earned over $107,000 from his trades.

Urging the court to dismiss the SEC's August 2021 complaint, Panuwat argued that the SEC failed to adequately plead the requisite elements of a securities fraud claim, materiality, breach of duty, and scienter. He also argued the SEC's novel application of the misappropriation theory was an "unprecedented expansion" of the Exchange Act in violation of his due process rights.

[1] The practice received the moniker "shadow-trading" in a paper posted in September 2020. *See* Mihir N. Mehta, and David M. Reeb, Wanli Zhao, *Shadow Trading*, The Accounting Review, July 2021, Available at SSRN: https://ssrn.com/abstract=3689154.

Panuwat argued that the SEC failed to plead that the information regarding Pfizer's impending Medivation acquisition was material to Incyte because Rule 10b-5 required the SEC to plead that Panuwat had traded Incyte securities based on material, nonpublic information about Incyte. Instead, Panuwat argued, the SEC's claim rested on Panuwat's possession of nonpublic information about Medivation. In response, the SEC argued Panuwat's proposed reading of Rule 10b-5 improperly narrowed the meaning of materiality when the language of Section 10(b) and Rule 10b-5 contemplate that information can be material to more than one company.

Judge Orrick rejected Panuwat's materiality arguments, agreeing with the SEC that Section 10(b) and Rule 10b-5 broadly prohibit insider trading of "any security" using "any manipulative or deceptive device." *See* § 15 U.S.C. § 78(j)(b); 17 C.F.R. § 240.10b-5. Judge Orrick noted that Rule 10b-5 is silent about the source of information, requiring only that information be material and nonpublic. Thus, information can be material to the issuer of a security even if the source of the information is different from the company issuing the traded security. Given the SEC's allegations of the limited number of mid-cap, oncology-focused biopharmaceutical companies, Judge Orrick found that the SEC had plausibly alleged that information about Pfizer's impending acquisition of Medivation could be material to Incyte. Judge Orrick also held that information about the impending acquisition was confidential and nonpublic.

The court also found that the SEC had adequately pleaded that Panuwat breached his duty to Medivation under the plain language of the company's insider trading policy, which applied to "the securities of another publicly-traded company including significant collaborators, customers, partners, suppliers, or competitors." Because Incyte is a publicly-traded company, Judge Orrick found Medivation's policy applied to the trading of Incyte's securities. Addressing the scienter element, Judge Orrick held that the SEC had adequately pleaded that Panuwat had the requisite intent to use material non-public information to trade the Incyte securities based on the timing of Panuwat's trades—within minutes of acquiring the information—and the fact that Panuwat had never previously traded in Incyte securities. Finally, Judge Orrick rejected Panuwat's due process argument that the parameters of insider trading laws would become "entirely unclear" should the case proceed to discovery because materiality and scienter "provide sufficient guardrails to insider trading liability."

As Judge Orrick noted, *SEC v. Panuwat* is the first misappropriation theory case the SEC has brought arguing that nonpublic information could be material to investors of another company where the companies are merely peers in the market. The SEC's willingness to bring a case applying a never-before-litigated theory of liability demonstrates a renewed robust interest in pursuing corporate enforcement actions by the current Administration. While Judge Orrick's decision is a preliminary victory for the SEC, the case is far from over. Nevertheless, companies may wish to review the scope of their insider trading policies, ensure their employees understand the policies, and take additional steps to prevent shadow trading, including making potential adjustments to their compliance and surveillance programs.

Walden Macht & Haran LLP (WMH) can assist in crafting targeted and cost-effective solutions to satisfy legal obligations and safeguard against future wrongdoing. WMH has substantial experience understanding and addressing the unique challenges entities face when their internal compliance practices are subject to an SEC enforcement action. We identify key deficiencies, root causes, and recommend workable solutions to build effective and sustainable compliance programs.

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