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"Shadow Trading" is Insider Trading: Jury Establishes Liability in Historic Shadow Trading Case

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On April 5, 2024, a jury found Matthew Panuwat civilly liable for insider trading in violation of federal securities laws[1] in a first-of-its-kind "shadow trading" case (also referred to as "sympathy trading"), which was commenced by the U.S. Securities and Exchange Commission (SEC) on August 17, 2021.[2] Following a historic trial in the U.S. District Court for the Northern District of California (Court), the SEC stated that the case was not novel and that Panuwat's actions fell squarely within the misappropriation theory of insider trading.[3] This case, however, is the first instance in which the SEC successfully argued that (i) a company's material nonpublic information (MNPI) may be material to a wholly different company if both companies have a "market connection" or are "economically linked," and (ii) trading securities of one company while in possession of MNPI of a different market-connected or economically linked company (even if the MNPI does not directly relate to the traded company's securities) can nevertheless give rise to a violation of federal securities laws. Accordingly, this case affirmatively expands on the existing theories of insider trading liability to now include trading in the securities of a company other than the company to which the MNPI directly relates, provided that both companies have a market connection or are economically linked.[4] We examine the salient details of the Panuwat case and the potential implications below.

Background

In 2016, Panuwat was the Senior Director of Business Development at Medivation Inc., a California-based oncology-focused mid-cap biopharmaceutical company. As part of his employment, Panuwat signed Medivation's insider trading policy, which precluded employees from using information about Medivation to trade in its securities "or the securities of another publicly traded company."[5] Amid Medivation's efforts to find a suitable acquirer, Panuwat and other senior employees received an email from Medivation's Chief Executive Officer on August 18, 2016 (CEO Email) that contained the information that Pfizer Inc. would acquire Medivation. Seven minutes after receiving the CEO Email, Panuwat purchased 578 call options in InCyte Corp., a comparable peer to Medivation, days before Medivation's public announcement that Pfizer would acquire Medivation. On August 22, 2016, Pfizer's acquisition of Medivation was disclosed to the public, which resulted in the stock price of Incyte increasing by 7.7 percent. Two days after the announcement of the Pfizer-Medivation acquisition, Panuwat sold 300 of his call options for a profit, and he sold the remainder of his call options in September 2016. As a result, Panuwat ultimately made approximately $120,000 from his trading activities with respect to the call options.

On August 17, 2021, the SEC charged Panuwat with violating Section 10(b) of the Securities Exchange Act of 1934 (Exchange Act) and Exchange Act Rule 10b-5 thereunder.

Panuwat's Motion for Summary Judgment Denied

On November 20, 2023, the Court denied Panuwat's motion for summary judgment. A key question was whether the SEC could sufficiently show a "market connection" between Medivation and Incyte. Notwithstanding Panuwat's argument that Medivation

[1] https://www.sec.gov/litigation/litreleases/lr-25970.
[2] https://www.sec.gov/files/litigation/complaints/2021/comp-pr2021-155.pdf.
[3] https://www.sec.gov/news/statement/grewal-statement-040524.
[4] *See* https://www.lowenstein.com/news-insights/publications/client-alerts/sympathy-trading-sec-seeks-to-expand-insider-trading-liability-investment-management.
[5] https://www.sec.gov/files/litigation/complaints/2021/comp-pr2021-155.pdf.

and Incyte were “fundamentally different companies” given that they did not share approved drug products or develop the same drugs, the SEC proffered evidence that suggested that the market did not perceive the companies to be “undisputedly different” from each other. The SEC pointed to several analyst reports and financial news articles that consistently linked Medivation’s acquisition to Incyte’s future acquisition prospects, along with noting that their stock performances were linked. Moreover, the “scarcity” value inherent in both companies’ status as midsize biotech companies with mid-cap cancer-related assets in the market was a significant driver of their overall value, and, therefore, such scarcity was “at least speculated to translate into market value.” Incyte’s stock price increase of 7.7 percent following the public announcement of the Pfizer-Medivation acquisition also served as “strong evidence” that investors understood the significance of the information to Incyte. Relying on the foregoing and the fact that Rule 10b-5 does not require that “material” information about an issuer or its securities be necessarily derived from the issuer itself, the Court ruled that a jury could find that a reasonable investor might understand information about one company’s acquisition to “alter the total mix of information” about the other, making the news about the Medivation acquisition material to Incyte.

Panuwat’s Civil Jury Trial

On March 25, 2024, the civil jury trial against Panuwat commenced in the Court. While Panuwat argued that the SEC lacked evidence proving scienter, the SEC pointed to key facts that appeared to weaken Panuwat’s position that his trades in Incyte were unrelated to the MNPI he possessed about Medivation. For example, Panuwat had never previously traded Incyte securities, and his first purchase, for call options, occurred a mere seven minutes after his receipt of the CEO Email. Moreover, the trades represented a significant divergence from Panuwat’s prior trading history, which typically consisted of long common stock and mutual fund purchases. On April 5, 2024, after an eight-day jury trial and a few hours of deliberation, the SEC obtained a verdict in its favor.

Key Takeaways

The SEC remains firm in its belief that this case did not present any novel issues, reasoning that Panuwat’s actions fell squarely within the misappropriation theory of insider trading. Nevertheless, many industry participants disagree and note that the decision ostensibly expands the scope of insider trading liability in new ways that now include shadow trading. Novel or not, the Panuwat case makes clear that the SEC has an additional tool in its enforcement arsenal to combat insider trading. In the wake of the Panuwat case, investment adviser firms and legal and compliance professionals should consider reviewing their current compliance programs and should consider further developing and refreshing their compliance programs based on these new developments, as further explained below.

The current state of compliance programs typically utilizes securities watchlists and/or restricted lists in the implementation of their insider trading policies and procedures in conjunction with training. Such compliance programs seek to evaluate and restrict their employees’ contact points with MNPI and limit their opportunities to trade securities in those companies about which they directly possess MNPI. In the aftermath of the Panuwat case, we expect that an effective compliance regime will require that this analysis be broadened. Moving forward, as part of the evaluation process described above, investment adviser firms should “take inventory” and consider carefully conducting additional sector-based analysis to identify specific companies that have a market connection or are economically linked. To the extent that companies with market connections or economic links are identified, investment adviser firms should consider adding such companies to their restricted lists when in possession of MNPI about a company with a market connection or an economic link. Investment adviser firms should take a thoughtful and tailored approach to this sector-based analysis–policies that indiscriminately restrict all trades within a certain sector (unless the sector is very narrow and all companies within it have market connections or are economically linked) will often be overbroad and unworkable.

An investment adviser firm may be more exposed to the risk of shadow trading depending on, among other things, its operations and investment strategy. For example, investment adviser firms that engage in thematic investing strategies, hold board seats on or board observer rights in their portfolio companies (both private and publicly traded companies), or become “wall-crossed” in connection with investment opportunities might be particularly exposed to such risks.

The Panuwat case may be appealed; therefore, the ultimate outcome is still pending. Nevertheless, the SEC has made clear its intention to treat cases of shadow trading as normal course insider trading activity. Investment adviser firms should actively consider the implications of the SEC’s stance on this issue as it relates to their trading and compliance activities. Such firms may wish to consult with counsel to better assess whether their current compliance policies and procedures properly account for and mitigate the risk of shadow trading activities.

Please contact any of the listed authors of this Client Alert or your usual Lowenstein Sandler contact if you have any questions with respect to this new SEC case, any insider trading issues, or any other related matters.

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