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SEC's shadow trading case survives motion to dismiss

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A novel insider trading case for trading the stock of a company that the trader did not work for and that was not the target in the M&A transaction has drawn attention for its possible implications for public companies and trading firms.

Last week, a federal judge in California denied a motion to dismiss a novel SEC action alleging what has become known as "shadow insider trading"— trading in the securities of a company other than the company the defendant knew was the target of a confidential takeover bid. The case will now proceed to discovery and perhaps trial.

The defendant in this suit, Matthew Panuwat, was an executive at Medivation, a "mid-cap, oncology-focused biopharmaceutical company." Panuwat had signed the company's insider trading policy, which prohibited him from using nonpublic information to trade for his personal benefit "in the Company's securities … *or the securities of another publicly traded company*, including all significant collaborators, customers, partners, suppliers, *or competitors* of the Company" (emphasis added).

In August 2016, Panuwat received an email from Medivation's CEO indicating that an acquisition of Medivation was imminent. According to the SEC, "within minutes of receiving that email," Panuwat purchased hundreds of short-dated, out-of-the-money call options, not for Medivation, but for Incyte Corp., another mid-cap oncology drug company similar to Medivation. The SEC alleged that Panuwat purchased the options because he knew that the soon-to-be-announced acquisition of Medivation would likely cause Incyte's stock price to rise; the two companies were similar enough that the acquisition of Medivation would cause the market to consider Incyte to be an appealing merger target as well. And indeed, after the news of the merger became public, Incyte's stock price rose substantially and Panuwat's options trade earned him a profit of $107,066. The SEC filed a complaint against Panuwat, alleging that he knowingly breached his duty to Medivation by trading on the basis of material nonpublic information that he received through his employment.

The lawsuit is the first attempt by the SEC to extend the "misappropriation theory" of insider trading to cover trading in the securities of a company as a result of possession of material nonpublic information about the impending takeover of a different, economically similar company. Under the misappropriation theory, as explained by the Supreme Court in 1997, a person commits securities fraud "when he misappropriates confidential information for securities trading purposes, in breach of a duty owed to the source of the information." Until now, the SEC had not brought a case under the misappropriation theory against a defendant who had traded in the securities of a company other than the company about which he possessed nonpublic information that it was a takeover target.

In denying the motion to dismiss, the court cited the language of Section 10(b) of the Securities Exchange Act of 1934—which refers to "any manipulative or deceptive device" concerning "any security"—and similarly broad language in Rule 10b-5, in holding that information about one company can be material to another company. The court also held that the SEC had pleaded in sufficient detail that, given the small number of similar companies, the acquisition of one company could make others more attractive targets and drive up their stock prices. The court also cited the language of the statute and rule in rejecting Panuwat's argument that the extension of the misappropriation theory to cover shadow insider trading violated his due process rights.

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Takeaways

The precedential impact of the case might be limited because of the particular facts alleged by the SEC–namely, a very tight connection between two similarly-sized companies in a focused industry and the fact that the defendant was allegedly told by Medivation's bankers that Incyte was similarly situated to Medivation. Nevertheless, this novel insider trading case has drawn attention throughout the securities industry because of its possible implications, and because the SEC's success on this motion may encourage the agency to pursue novel enforcement theories in a variety of areas.

Public companies should note that Medivation's insider trading policy, which is central to the SEC's allegations, was broadly worded to cover the use of confidential information to trade the securities of any publicly traded entity. Public companies may want to review their insider trading policies in light of the SEC's focus in this case. Under the SEC's recently proposed rules on Rule 10b5-1 and insider trading, companies would be required to disclose whether they have adopted insider trading policies and procedures that are reasonably designed to promote compliance with insider trading laws.

In addition, investment advisers and broker-dealers frequently maintain restricted trading lists of companies about which they have obtained material nonpublic information. Trading firms should note that the SEC might allege an insider trading theory for trading securities of companies other than the company about which a firm has specific material nonpublic information (*e.g.*, it is the subject of a confidential takeover bid) because such information also is alleged to be material to a different company. These firms also might want to consider whether they have signed a nondisclosure agreement with terms that would cover trading in the securities of companies other than the counter-party, akin to Medivation's insider trading policy.

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