February 2022

The SEC's New Insider Trading Theory: Implications for Public Companies and Investment Firms

By Kenneth P. Herzinger, Nick Morgan, John P. Nowak, Thomas A. Zaccaro & Jessica Baker

A federal district court in California recently held that the SEC's new theory of insider trading, coined "shadow trading," is a viable theory under the federal securities laws.[1] The SEC's complaint in that case alleged that Matthew Panuwat, a former employee of Medivation, Inc. ("Medivation"), misappropriated material nonpublic information ("MNPI") concerning Medivation and then committed insider trading by purchasing options in a close competitor of Medivation (the "Competitor"). The MNPI specifically related to Medivation's acquisition by another public company—it did not relate to the Competitor. Nevertheless, the SEC alleged that Panuwat anticipated that the Competitor's stock price would materially increase on the news of Medivation's acquisition and that the MNPI was material to the Competitor. This is the first time that the SEC has alleged insider trading where the MNPI at issue was not directly related to the securities that were purchased or sold. Although the SEC's pursuit of insider trading violations is nothing new, this "shadow-trading" theory of liability will have implications for issuers, broker-dealers, and investment advisers, especially now that a court has found it to be a viable theory for the SEC to pursue.

As noted below, public companies should review their insider trading policies in light of the SEC's "shadow-trading" theory, as well as their pre-clearance procedures. Additionally, investment advisers and broker-dealers should evaluate whether their respective policies and procedures should account for any risks associated with the SEC's new theory.

Background: Panuwat Purchased the Competitor's Securities

The SEC alleged that Panuwat, who served as Medivation's Senior Director of Business Development at the time, was involved in Medivation's efforts to evaluate its strategic options and was responsible for tracking Medivation's performance and stock price in relation to its competitors. In 2016, Medivation engaged investment bankers to explore a possible sale of the company. The SEC alleged that, during 2016, Panuwat received information from the investment bankers comparing Medivation to its competitors, including the Competitor, and indicating that bidders were willing to pay a premium for Medivation.

According to the SEC, in August 2016, Medivation's CEO sent Panuwat, among others, an email relaying that another public company had expressed a strong interest in acquiring Medivation and that the CEO of Medivation would have a call that same day to work through final details. Within minutes of receiving this email, Panuwat purchased call options in the Competitor. The SEC alleged that Panuwat anticipated that the Competitor's stock price would increase when Medivation's acquisition was announced, primarily because the Medivation announcement made it a more valuable acquisition target. Panuwat allegedly did not pre-clear the trade or inform anyone about the purchase. Days later, Medivation publicly announced that it had entered into an agreement and plan of merger. The SEC alleged that the Competitor's stock rose approximately 8% following this announcement, and that Panuwat earned $107,066 of illicit profits by purchasing the securities ahead of the announcement.

SEC's Shadow-Trading Theory Survives Panuwat's Motion to Dismiss

Panuwat has contested the allegations, and recently, the district court denied his motion to dismiss. In its opinion, the court found that the SEC's complaint adequately pled a violation of Section 10(b) of the Securities Exchange Act of 1934, and that the alleged MNPI did not have to relate directly to the Competitor or its securities. The court agreed with the SEC that the MNPI does not have to originate from the Competitor to be material, primarily because Section 10(b) and Rule 10b-5 broadly prohibit insider trading of "any security" using "any manipulative or deceptive device." The court also rejected Panuwat's argument that information about a merger is only material to the two entities negotiating the transaction. The court focused on the fact that there are a limited number of companies in Medivation and the Competitor's industry, which made it reasonable to infer that the acquisition of one such company could be material to that company's close competitors.

The SEC had alleged that Panuwat owed Medivation a duty not to trade on MNPI as a result of his employment and because of the prohibitions contained in the company's insider trading policy. Medivation's insider trading policy specifically prohibited employees from buying or selling either Medivation's securities "or the securities of another publicly traded company," including certain enumerated categories (e.g., customers, partners, or competitors of Medivation) on the basis of MNPI. In ruling in favor of the SEC, the court found that the SEC had adequately pled that Panuwat breached a duty to Medivation as a result of the language in the insider trading policy. The court rejected Panuwat's argument that the SEC was required to allege that the Competitor fell within one of the enumerated categories referenced in the policy, primarily because the policy used the word "including," indicating that the categories were non-exhaustive examples.

The court also rejected Panuwat's argument that this novel theory would improperly expand the misappropriation theory of insider trading and violated his due process rights. The court noted that the SEC's theory comported with two principles underlying the misappropriation theory—that it reaches corporate outsiders and recognizes that information can be material to more than one company—as well as the expansive language of Section 10(b) and the rules promulgated thereunder.

The Takeaways

This action presents many takeaways and reminders for both public companies and regulated entities (investment advisers and broker-dealers):

- Confidential information about one company can be material to other companies, and insider trading liability might attach even when the information at issue is not directly related to the company whose securities are traded.
- Issuers, broker-dealers, and investment advisers should:

   - carefully review their insider trading policies to determine whether the policies do (or should) contain language prohibiting trading in the securities of a third-party company pursuant to a shadow-trading theory;

   - communicate with counsel who is familiar with SEC developments in this area to address shadow-trading concerns as this theory continues to develop; and

   - provide *ad hoc* and annual training on insider trading that considers this new theory.

- Broker-dealers and investment advisers should expect the SEC’s Examinations staff to ask about insider trading policies in relation to shadow trading when evaluating a firm’s obligations pursuant to Section 15(g) of the Exchange Act and Section 204A of the Investment Advisers Act of 1940.

- Broker-dealers and investment advisers should engage in a risk assessment to determine whether risks associated with shadow trading exist in connection with the regulated entity’s business. Among other things, they should consider the various sources of potential MNPI, including:

   - confidentiality agreements with issuers; and

   - situations where firm personnel serve as directors of portfolio companies.

- Issuers, broker-dealers, and investment advisers should evaluate their MNPI trading policies to determine whether:

   - pre-clearance procedures should apply to trading in third-party companies;

   - trading windows or blackout periods should apply to trading in third-party companies; and

   - additional consideration should be given when potential MNPI is of such a magnitude that it might materially affect the securities of another company, especially where the company is a close competitor or where the sector of the market contains only a few companies.

✧ ✧ ✧

If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings lawyers:

Los Angeles

Nick Morgan
1.213.683.6181
nicolasmorgan@paulhastings.com

Thomas A. Zaccaro
1.213.683.6185
thomaszaccaro@paulhastings.com

New York

John P. Nowak
1.212.318.6493
johnnowak@paulhastings.com

San Francisco

Kenneth P. Herzinger
1.415.856.7040
kennethherzinger@paulhastings.com

[1] *SEC v. Panuwat,* No. 21-cv-06322 (N.D. Cal. Aug. 17 2021).