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SEC Wins Trial Involving First-Ever Shadow Trading Case

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On April 5, 2024, a federal jury in the Northern District of California found defendant Matthew Panuwat liable for insider trading in the Securities and Exchange Commission's ("SEC") first-ever case involving the so-called "shadow trading" theory of insider trading.

The SEC's shadow trading theory is an extension of the well-established misappropriation theory of insider trading adopted by the Supreme Court in 1997.[1] The SEC's shadow trading allegations, the district court's orders denying Panuwat's motion to dismiss and motion for summary judgment, and the jury verdict provide several important lessons for companies, investment professionals, and investors.

I. Background

A. Basic Legal Background of Insider Trading

In general, an insider trading violation has the following elements: (1) trading (2) on the basis of (3) material, nonpublic information (4) in violation of a duty of trust and confidence to the source of that information.[2] Under the misappropriation theory of insider trading, a person who is not an insider at a company nevertheless engages in illicit insider trading if the person lawfully comes into possession of material, nonpublic information, but then breaches a duty of trust and confidence owed to the source of the information by trading on the basis of that information, or by conveying the information to another person to trade.

The shadow trading theory extends the misappropriation theory to situations where a person lawfully acquires material, nonpublic information but, instead of trading in the securities of the company to which the person owes a duty of trust and confidence, the person uses the information to trade in the securities of *another* company to which the person does not owe such a duty.[3]

As discussed below, the SEC's case against Panuwat involved this shadow trading theory, and the court's analysis of the theory focused on the "materiality" and "duty of trust and confidence" elements of insider trading.

B. Factual Background of SEC v. Panuwat

In 2021, the SEC sued Matthew Panuwat for engaging in insider trading. The alleged facts of the case are unique.[4] The SEC alleged that Panuwat, while serving as a Senior Director of Business Development at a biopharmaceutical company ("Company A"), received material, nonpublic information that Company A would be acquired by a larger pharmaceutical company. The SEC alleged that, after

receiving this information, Panuwat purchased out-of-the-money, short-term stock options in another biopharmaceutical company ("Company B"), whose shares, according to the SEC, Panuwat anticipated would increase once the acquisition of Company A was announced. Later, when the acquisition of Company A was announced publicly, both Company A's and Company B's stock prices rose considerably, and the SEC alleged that Panuwat earned $107,066 as a result of the exercise of his Company B options.

The SEC alleged that Panuwat owed Company A a duty to maintain in confidence the material, nonpublic information about the acquisition and to refrain from trading on the basis of Company A's confidential information. According to the SEC, this duty arose from Panuwat's employment at Company A and the confidentiality and insider trading policies that he signed.[5]

The SEC alleged that the information about the acquisition was material to Company A *and* Company B because Company B was Company A's peer: Both companies operated in the biopharmaceutical industry and were publicly traded, mid-cap companies focused on oncology. In view of these similarities, the SEC alleged that information about the undisclosed acquisition was material to Company A *and* Company B because the information would have been viewed by a reasonable investor of either company as having significantly altered the total mix of information available.[6] Specifically, the SEC alleged that the public announcement of Company A's acquisition likely would have a positive effect on Company B's stock price.[7]

Panuwat moved to dismiss the complaint. He argued that he had not breached a duty to Company A by trading the securities of Company B. Panuwat also argued that information about the acquisition involving Company A was not material to Company B. As discussed below, the district court rejected both arguments and denied Panuwat's motion to dismiss. Later, the district court rejected similar arguments when it denied Panuwat's motion for summary judgment.

II. The District Court's Legal Reasoning

A. The District Court Ruled that Panuwat's Duty of Trust and Confidence Could Arise from Company A's Insider Trading Policy, Panuwat's Confidentiality Agreement with Company A, and Traditional Agency Law.

In his motion to dismiss, Panuwat argued that he did not breach his duty of trust and confidence to Company A because Company A's insider trading policy did not expressly prohibit trading in Company B's securities.[8] Company A's insider trading policy prohibited trading the securities of publicly traded companies, including significant collaborators, customers, partners, suppliers, or competitors of Company A. Panuwat argued that Company B did not fall into one of these specific categories.[9]

The district court rejected this argument. The district court cited the "plain language" of Company A's policy, which prohibited trading "the securities of another publicly traded company, *including*" the specific categories cited by Panuwat.[10] The district court stated that the word "including" did not limit the policy's applicability to only the types of companies listed. Rather, those companies were mere examples of what the policy covered. According to the district court, because Company B was a publicly traded company, Company B was covered by Company A's insider trading policy.[11]

In denying Panuwat's subsequent motion for summary judgment, the district court again relied on Company A's insider trading policy, but the district court also pointed to additional sources for Panuwat's duty of trust and confidence to Company A.[12] The district court reviewed Panuwat's confidentiality agreement with Company A and stated that "the facts could support a jury finding that Panuwat (a) owed [Company A] a duty of confidentiality and trust that arose when he signed the Confidentiality

Agreement, (b) obtained confidential information about [Company A's] sale process . . . , and (c) exploited that information for his personal benefit when he bought [Company B] stock options . . . and later sold those options for a profit."[13] The district court also cited Panuwat's duty to his employer, stating, "Panuwat's duty arose from his employment with [Company A]. He was entrusted with confidential information by [Company A]. He breached his duty when he traded on it for his own personal benefit without disclosing that fact to [Company A]."[14]

B. The District Court Ruled that Information about Company A Could Be Material to Company B Because of the Market Connection Between the Companies.

In his motion to dismiss, Panuwat argued that information about the acquisition of Company A was not material to Company B. The district court rejected this argument and focused on the market connection between Company A and Company B. According to the district court, the complaint sufficiently alleged that "given the limited number of mid-cap, oncology-focused biopharmaceutical companies with commercial-stage drugs in 2016, the acquisition of one such company ([Company A]) would make the others (i.e., [Company B]) more attractive, which could then drive up their stock price."[15] The district court found that "[g]iven the number of other companies who tried to acquire [Company A]," it also was "reasonable to infer that those that were unsuccessful would then turn their attention to [Company B]," and therefore, news about the acquisition would be important "in deciding whether to buy or sell [Company B] stock."[16] The district court said that these inferences were confirmed by the SEC's allegation that Company B's stock price increased on the day that the acquisition of Company A was announced.[17]

In denying Panuwat's subsequent motion for summary judgment, the district court again focused on the market connection between Company A and Company B.[18] The district court ruled that a reasonable jury could infer that "a reasonable investor such as Panuwat—who paid careful attention to the biopharmaceutical market, and specifically to [Company B]—could have perceived [Company A] and [Company B] to be connected in the market such that pertinent information about one was material to the other."[19] With respect to the market connection between Company A and Company B, the district court observed that "[i]n the small pool that the two companies occupied, where scarcity was at least speculated to translate into market value, 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 that news material to [Company B]."[20]

III. Navigating the SEC's Shadow Trading Theory

The SEC's shadow trading theory and the district court's legal reasoning present several key lessons. To navigate this new and evolving theory, companies, investment professionals, and investors should consider the following:

Insider Trading Policies Inadvertently May Create Duties. The SEC's complaint in *Panuwat* and the district court's denial of Panuwat's motion to dismiss illustrate that a duty could arise from company policies regarding insider trading. Unless narrowly tailored, such policies may impose broad duties and trading restrictions. Companies and financial services firms should consider the *Panuwat* case when drafting their policies and make conscious, informed decisions about whether to adopt policies that may impose duties beyond the requirements of the federal securities laws.

Be Mindful of the Language in a Non-Disclosure Agreement ("**NDA**"). Following *Panuwat*, there has been a greater focus on the breadth of the language in an NDA. Investment funds have pushed for

more narrowly tailored language that restricts trading only in the issuer at hand. Issuers, on the other hand, have been less willing to agree to such narrow language.

Disclaimers in an NDA May Not Be Enough. For investment funds and investors, a provision in an NDA that either disclaims a duty to the source of the confidential information or is narrowly tailored to a single company may not be sufficient to avoid shadow trading liability if the investment fund has an insider trading policy similar to the policy in *Panuwat* that prohibits trading in the securities of any other company.

Financial Services Firms May Need To Revise Their Restricted Lists, **Supervisory and Surveillance Programs, and Information Barriers**. In light of *Panuwat*, financial services firms should consider whether their "restricted" lists (and associated pre-clearance procedures), communications surveillance programs, and information barriers should be expanded to cover other companies in the same industry. If there is a sufficient market connection between companies, then material information about one company also could be material information about another company.[21] When evaluating the strength of the market connection among companies, firms should consider the number of companies in the industry with a similar market capitalization and focus.

Training Should Include the *Panuwat* Fact Pattern. Insider trading training programs should include the *Panuwat* fact pattern and inform personnel about the potential risks associated with *any* trading on the basis of material, nonpublic information about *any* company. For example, companies should make sure that insiders are aware of the risks of trading in the securities of peer firms on the basis of material, nonpublic information learned about their employer or other peer firms. Financial services firms should train their personnel on the risks of trading, or advising clients to trade, in the securities of a company while in possession of material, nonpublic information about another company in the same industry.

IV. Conclusion

The *Panuwat* case is a first-of-its-kind fact pattern for an SEC enforcement case. Although it remains to be seen whether the SEC will continue to bring cases alleging similar facts, companies, investment professionals, and investors should take appropriate steps in response to *Panuwat*.

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[1] *See United States v. O'Hagan*, 521 U.S. 642, 652 (1997).

[2] For more information about the misappropriation theory and other theories of insider trading, see Bradley J. Bondi and Michael D. Wheatley, *The Law of Insider Trading: Legal Theories, Common Defenses, and Best Practices for Ensuring Compliance*, N.Y.U. J. Law & Bus. Vol. 19: 2 (Spring 2023).

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[3] *See* Order Denying Motion to Dismiss, *SEC v. Panuwat*, Case No. 3:21-cv-06322-WHO (N.D. Cal. Jan. 14, 2022), ECF No. 26 at 5 (hereinafter "Order Denying Motion to Dismiss") ("The SEC brings its claim against Panuwat under the misappropriation theory.").

[4] Even though the SEC has said that "there is nothing novel about" the *Panuwat* case, at oral argument on the motion to dismiss, the SEC conceded that there were no other similar cases where the material, nonpublic information at issue involved a third party. *Compare* Gurbir S. Grewal, Director, Division of Enforcement, *Statement on Jury's Verdict in Trial of Matthew Panuwat* (Apr. 5, 2024) (https://www.sec.gov/news/statement/grewal-statement-040524) *with* Order Denying Motion to Dismiss at 12.

[5] *See* Complaint, *SEC v. Panuwat*, Case No. 3:21-cv-06322-WHO (N.D. Cal. Aug. 17, 2021), ECF No. 1 at 7–8 (hereinafter "Complaint").

[6] *See id*. at 7.

[7] *See id*.

[8] *See* Motion to Dismiss, *SEC v. Panuwat*, Case No. 3:21-cv-06322-WHO (N.D. Cal. Nov. 1, 2021), ECF No. 18 at 11–12 (hereinafter "Motion to Dismiss").

[9] *See id*. at 11.

[10] *See* Order Denying Motion to Dismiss at 9 (emphasis by the district court).

[11] *See id*.

[12] *See* Order Denying Defendant's Motion for Summary Judgment, *SEC v. Panuwat*, Case No. 3:21-cv-06322-WHO (N.D. Cal. Nov. 20, 2023), ECF No. 85 at 15–20 (hereinafter "Order Denying Motion for Summary Judgment").

[13] *Id*. at 18.

[14] *Id*. at 19.

[15] Order Denying Motion to Dismiss at 7–8.

[16] *Id*.

[17] *See id*.

[18] Order Denying Motion for Summary Judgment at 8–9 ("whether a market connection exists between [Company A] and [Company B] is critical for materiality.").

[19] *Id*. at 10.

[20] *Id*. at 11.

[21] *See* Securities and Exchange Commission Division of Examinations, Risk Alert: Investment Adviser MNPI Compliance Issues at 3 (Apr. 26, 2022), *available at* https://www.sec.gov/files/code-ethics-risk-alert.pdf (stating that the SEC staff observed investment advisers that did not have adequate policies and procedures regarding "[r]eviewing relevant trading activity of supervised persons in the securities of publicly traded companies *that are in similar industries* as those discussed during [expert networking] calls") (emphasis added).