SEC BRINGS FIRST CASE CHARGING SHADOW INSIDER TRADING

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The SEC's filing of its first shadow trading case earlier this month signals the agency's willingness to pursue actions based on expanded theories of insider trading liability.

In a federal court complaint, the SEC on August 17 brought insider trading charges against Matthew Panuwat, a former business development executive at Medivation, Inc. based on trades he made after learning that the company was going to be acquired by a major biotechnology firm. The case is striking because it alleges not that Panuwat traded in his employer's stock, or in the stock of its anticipated acquirer, but rather that he purchased stock in a company "similarly situated" to Medivation.

The economic reasoning underlying the SEC's action is that Panuwat figured the acquisition of Medivation would also enhance the market value of similar or "shadow" companies. The legal theory of the case is that Panuwat had a duty to Medivation not to use information acquired in his role as a Medivation executive to benefit himself by securities trading, and that he misappropriated that information by using it to trade.

This misappropriation theory is not new, but its application to a shadow trade has widely been described as a first by the SEC's Enforcement Division.

The scope of insider trading liability beyond the classical paradigm of employees trading in their employer's stock has long been a subject of litigation and debate. A crucial issue in this litigation was resolved in 1997, when the U.S. Supreme Court adopted the misappropriation theory in *United States v. O'Hagan*, 521 U.S. 642 (1997). The Court affirmed a conviction on insider trading charges of a lawyer, working for a law firm representing a company planning a corporate acquisition, who traded in the stock of the target company.

Although the defendant was not an insider of the company in whose stock he was trading and thus did not owe a duty to its shareholders, he did owe a duty to his law firm and to its client, the putative acquirer. The breach of that duty by using the information to trade, the Court held, sufficed to impose insider-trading liability under Section 10(b) of the Securities Exchange Act of 1934.

In *SEC v. Panuwat*, brought in the U.S. District Court for the Northern District of California, the SEC alleges that Medivation's company policies barred employees from using confidential information they acquired at the company to trade in the stock of any other publicly traded company. Echoing *O'Hagan* and cases applying its approach, the complaint alleges that by violating company policy and breaching a duty to his employer, Panuwat is liable for insider trading.

According to the SEC complaint, Panuwat, then the Senior Director of Business Development at Medivation, moved quickly to invest once he learned of the impending acquisition in August 2016. It alleges that he had been involved in discussions within the company and with its investment banking advisers about potential acquisitions of Medivation, a mid-cap oncology company, and had also discussed the market for acquisition of other mid-cap oncology companies by larger pharmaceutical companies. It alleges that he had focused on one particular peer company, Incyte.

Then, on August 18, Panuwat was among the recipients of an email from Medivation's CEO reporting that a larger pharmaceutical company had "expressed overwhelming interest" in acquiring Medivation. Within minutes of receiving that email, the defendant allegedly logged on to his personal brokerage account from his work computer, and purchased 578 call option contracts in Incyte, which the SEC contends was based on his anticipation "that Incyte's stock would jump within less than a month on public disclosure of the upcoming Medivation announcement."

The deal was disclosed to the market on August 22, 2016. Medivation's stock price rose by 20 %, and Incyte's stock price rose by approximately 8 %, meaning that Panuwat profited from his options purchase.

The action goes beyond the *O'Hagan* fact pattern, in that the defendant traded in the stock of a company that was not a party to the proposed acquisition. That could give rise to defenses based on whether the information he had about the acquisition was material to trading in the stock of a company that was not a party to the acquisition, or other defenses related to the defendant's lack of any specific knowledge about the operations or finances of Incyte.

Scholarly articles discussing shadow trading have noted the rarity of prosecutions or enforcement actions relating to such trading. One reason given for that has been the difficulty of detecting activity in stocks not directly involved in the actual deal that affected the market price. The complaint and other public documents concerning the *Panuwat* action do not show how the Enforcement Division learned of the defendant's conduct.

The case also underscores the fact that the SEC's enforcement activity is not limited to multi-million dollar trades. The complaint alleges that Panuwat made profits on his trading of $107,066.

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