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Redefining Insider Trading

The SEC's Groundbreaking Theory in the Panuwat Case

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Key Takeaways

1. Just as employees and companies should not buy or sell their *own* company's stock based on material, nonpublic information, if the *Panuwat* decision stands they may not be able to buy or sell stock of another company based on their own company's nonpublic information about the other company.
2. Insider trading laws apply to certain trading by private companies and in private company stock as well as public company stock. So private companies and their employees should be aware of the changing landscape of insider trading laws and consider creating or updating controls for use or disclosure of material nonpublic information.

In *SEC v Panuwat*,[1] a federal jury in California will hear a novel insider trading theory that the court has allowed to proceed to trial. In *Panuwat*, the SEC says it is unlawful for an individual to purchase securities of a company even if neither the individual nor his employer possess any material nonpublic information from that company. The SEC argues it is unlawful to use non-public information from your employer to trade securities in an unrelated company if your employer's information is material to the unrelated company. This is the first time in the SEC's 90-year history that it has attempted to increase its enforcement authority over insider trading in this way. And it requires an arguably generous reading of the SEC's insider trading rule, which on its face applies to trading in a company security based on material inside information "about that security or issuer."[2] The Northern District of California court found the rule does not require the information "about" the issuer to "come from" the issuer itself for it to be material, and that information can be material to an issuing company even if it comes from outside the company.

The district court accepted the SEC's position that a peer company can have nonpublic information "about" another company that is material to the purchase of the other company's securities. The court also found the rule's language—that inside information coming from the issuer itself was "among other things" that could be a "manipulative or deceptive device"—leaves room for the SEC to prosecute insider trading beyond what is stated in the rule. A jury verdict in favor of the SEC, and survival of the verdict and the court's underlying legal opinions on appeal, will further expand the reach of the common-law created "misappropriation theory" of insider trading in the United States.[3]

Operative Facts

The SEC alleges that Panuwat used confidential information about the acquisition of his employer, Medivation, to buy stock options in a different company, Incyte Corp. Medivation was a mid-cap oncology-focused biopharmaceutical company and Panuwat was responsible for finding acquisition opportunities for Medivation. Panuwat signed Medivation's policies prohibiting insider trading and using the company's confidential information. Starting in March 2016, Medivation began exploring being acquired. Medivation's sales process was confidential. Panuwat was involved in this process. Panuwat received information from Medivation's CEO in April 2016 that Incyte Corp. was one of the very few mid-cap oncology biopharma companies left in the industry. Panuwat received information about how a larger

company acquiring Medivation could impact Incyte in the market. The market had a general idea about Medivation's sale process, but not the details as to buyers, timing, and pricing that Panuwat was privy to.

On August 14 2016, Panuwat received confidential information from Medivation's CEO that buyer bids were due on August 19 and the goal was to announce an acquisition on August 22. On August 18, 2016, Panuwat and 12 other Medivation employees received information that Pfizer wanted to close a deal to buy Medivation that weekend and named a specific price point. This information was not shared outside this group. Seven minutes later, Panuwat started purchasing Incyte call options. Over 33 minutes, he purchased 578 Incyte call options at three different strike prices, which represented between 70% and 84% of the daily volume of those call options sold in the market. Pfizer's acquisition of Medivation was announced on Monday, August 16 before the markets opened. That same day, Incyte's stock priced closed 7.7% higher than the prior trading day's close. On Wednesday, August 24, Panuwat sold 300 of the 578 call options for a profit. He sold the rest in September 2016. Panuwat made $120,031.32 from the trades.

Legal Structure of Insider Trading Enforcement

Like many of the securities enforcement laws in the U.S., the authority to prosecute insider trading is born largely from court decisions interpreting broadly-worded statutes and regulations.[4] Section 10(b) of the Securities Exchange Act of 1934 ("Exchange Act") makes it unlawful to employ "any manipulative or deceptive device" in connection with the purchase or sale of any security.[5] Rule 10b-5 makes it unlawful for any person to "directly or indirectly" employ "any device, scheme, or artifice to defraud," or participate in a course of conduct that operates as a "fraud or deceit," in connection with the purchase or sale of any security.[6] Rule 10b5-1 says that the "'manipulative or deceptive devices or contrivances' prohibited by Section 10(b) . . . and Rule 10b-5" include, "among other things," purchasing a security of "any issuer" on the basis "of material nonpublic information about that security or issuer," that breaches a duty of trust or confidence owed "to the issuer of that security . . . or to any other person who is the source of the material nonpublic information."[7]

There are two theories of insider trading that have developed in U.S. federal caselaw: 1) traditional or classical theory; and 2) misappropriation theory. Classical theory involves a corporate insider – typically a company employee, officer or director – trading shares of his company on the basis of material inside information from his company. Misappropriation theory reaches corporate outsiders who trade on material nonpublic information obtained in violation of a duty of loyalty and confidentiality owed to the source of the information.[8]

Panuwat is being prosecuted under the misappropriation theory; he is accused of trading on nonpublic information from Medivation that he knew was material to Incyte and that was obtained in violation of duties of loyalty and confidentiality he owed to Medivation.

***Panuwat* Provides a Legal Framework to Prosecute What Researchers Have Dubbed "Shadow Trading"**

In 2021, an academic researcher from the University of Michigan co-published a paper called "Shadow Trading." [9] The study defines this phenomenon as corporate insiders attempting to "circumvent insider trading restrictions by using their private information to facilitate trading in economically-linked firms." The study found "increased levels of informed trading among business partners and competitors before a firm releases private information." The study provides evidence that it says shows "shadow trading is an undocumented and widespread mechanism that insiders use to avoid regulatory scrutiny." The *Panuwat* case is the first prosecution of shadow trading, and the first opportunity to

document what the study says has been previously undocumented.

Court's Operative Findings

The district court's opinion denying Panuwat's motion to dismiss[10] sanctioned the SEC's new insider trading theory, and the court's opinion denying Panuwat's motion for summary judgment[11] held there was enough evidence for a jury to find in the SEC's favor under that theory. The following provides an application of facts around some key holdings related to the new shadow trading theory. All the action in this new theory is in the materiality element — whether Panuwat misappropriated "material nonpublic information" (MNPI) about Incyte. First, the court found the contents of the CEO's August 16 email – seven minutes after which Panuwat bought the Incyte options – material because a reasonable investor would have viewed it as altering the "total mix" of information available about Incyte. Critically, the court ruled that MNPI need only be "about" Incyte; it does not have to "come from" Incyte. So, a jury can now find that non-public information from Medivation about Incyte, and that is material to Incyte, satisfies the SEC's burden.

The district court held the jury could find the non-public information in the Medivation CEO's email about the details of its acquisition by Pfizer was material to Incyte because a jury could find a close market connection between Medivation and Incyte. The SEC and Panuwat jousted over whether analyst reports and other evidence showed a sufficient link between these two mid-cap oncology drug companies to find that Medivation's non-public information was material to Incyte. For example, the parties took different views of analyst reports about how Medivation's acquisition could affect Incyte's share price and place in the market, how closely the companies competed, the size of the relevant market, the number of competitors in the market, whether they were peers in that market, the similarity of their products, etc. There is an antitrust feel to the analysis. The court said this was a dispute for the jury to decide. Establishing the market connection between the company from whom non-public information was taken, and the materiality of that information to the company whose shares were purchased with it, will be important in any future shadow insider trading cases.

Also relevant to future shadow insider trading cases is that Panuwat was a "sophisticated investor with a robust history in trading." The SEC pointed to evidence showing Panuwat was an active trader, paid careful attention to the biopharmaceutical market, and commented positively on Incyte for months before his purchase. Panuwat said he was not trading that actively when he purchased the Incyte options, and that the options were consistent with his investment pattern from the previous quarter. Can future defendants argue that only sophisticated market participants can know enough about the "antitrust-type" market elements necessary to establish the required market connection in the shadow trading analysis? As to the nonpublic element, the court found the details about the price and timing of Medivation's acquisition by Pfizer in the CEO email was sufficiently nonpublic for the SEC to get to trial, even if there were public reports about Medivation's general interest in an acquisition and even if potential bidders, including Pfizer, had been publicly identified. The court also found sufficient circumstantial evidence that Panuwat read the CEO email and thus possessed Medivation's non-public information, despite his testimony about not remembering whether he had read it.

Whatever the outcome, this trial may be the first step on the SEC's road to establishing a shadow insider trading theory.

Should you wish to discuss the impact of these decisions or other matters related to shadow or insider trading, please contact your Miller Canfield attorney or the authors of this alert.

[1] N.D. Cal. Case No. 21-cv-0632-WHO (Orrick, J.).

[2] 17 CFR 240.10b5-1(a).

[3] Miller Canfield has written about the SEC's successful efforts to increase the range of insider-trading liability. *See* Matthew P. Allen, *US Supreme Court Affirms Broader View of "Personal Benefits" That Can Trigger Insider-Trading Liability* (Dec 9, 2016) (www.millercanfield.com/resources-Supreme-Court-Affirms-Broader-View-of-Insider-Trading.html); Matthew P. Allen, *Second Circuit Broadens "Personal Benefits" Triggering Insider Trading Liability* (Aug. 25, 2017) (www.millercanfield.com/resources-Second-Circuit-Broadens-Personal-Benefits-Triggering-Insider-Trading-Liability.html). This latest effort is arguably the SEC's most aggressive.

[4] *See, e.g.*, 17 CFR 240.10b5-1 ("Rule 10b5-1") ("The law of insider trading is otherwise defined by judicial opinions construing Rule 10b-5, and Rule 10b5-1 does not modify the scope of insider trading law in any other respect.").

[5] 15 USC 78j.

[6] 17 CFR 240.10b-5.

[7] 17 CFR 240.10b5-1.

[8] *See generally United States v. O'Hagan*, 521 US 642, 650-52 (1997).

[9] Mihir N. Mehta, *Shadow Trading*, 96 The Acct. Rev. (4) (Am. Acct. Ass'n July 2021).

[10] 2022 WL 633306 (N.D. Cal. Jan 14, 2022).

[11] 2023 WL 9375861 (N.D. Cal. Nov. 20, 2023).