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Legal Sidebar

SEC's First "Shadow Trading" Case Slated for Trial

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Corporate insiders commit securities fraud when they trade their firms' shares on the basis of material nonpublic information (MNPI). A pending Securities and Exchange Commission (SEC) enforcement action raises a related but novel issue: is it unlawful for corporate insiders to use MNPI derived from their employment to trade the securities of *similar* companies? One recent study concludes that this practice—dubbed "shadow trading"—is widespread, meaning the case may have important implications for insider trading law and corporate compliance departments. The litigation may also be of interest to Congress in its oversight of the enforcement of the securities laws.

This Legal Sidebar provides an overview of insider trading doctrine, the SEC's enforcement action, and considerations for Congress.

Insider Trading: Doctrinal Background

Insider trading is governed by several distinct legal schemes. For purposes of this Sidebar, the relevant provisions of federal law are Section 10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b-5, which prohibit specified forms of securities fraud.

Neither provision explicitly mentions transactions by corporate insiders. The modern prohibition of insider trading that has emerged from Section 10(b) and Rule 10b-5 is instead the product of common-law decisionmaking by courts and the SEC. The scope of the prohibition has fluctuated over the years as competing theories—one grounded in the value of equal access to information, the other in fiduciary duty—have vied for supremacy.

Origins: The Equal Access Approach

The SEC deployed Rule 10b-5 to target open-market insider trading for the first time in 1961. In an administrative enforcement action—*In re Cady, Roberts & Co.*—the SEC concluded that a brokerage-firm partner violated Rule 10b-5 by selling shares of the Curtiss-Wright Corporation after learning of an impending dividend cut from one of the corporation's directors, but before the cut was announced to the public. In its opinion, the SEC articulated what came to be known as the "disclose or

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abstain" rule, which provides that persons with access to MNPI must either disclose such information prior to trading a corporation's securities or abstain from trading. This duty, the SEC reasoned, rested on "two principal elements":

> (1) "the existence of a relationship giving access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone"; and
>
> (2) "the inherent unfairness involved where a party takes advantage of such information knowing it is unavailable to those with whom he is dealing."

Cady, Roberts represented a notable expansion of Rule 10b-5, but it was only an administrative decision. Judicial confirmation of the SEC's position came seven years later with the Second Circuit's decision in *SEC v. Texas Gulf Sulphur Co*. The case involved insiders at a mining company who had purchased the company's shares and options to acquire its shares after the firm discovered promising mineral deposits, but before the discovery was announced to the public. The Second Circuit agreed with the SEC that this conduct violated Rule 10b-5. Citing *Cady, Roberts*, the court announced a broad rule under which "anyone" in possession of MNPI regarding a company's securities must either disclose it or abstain from trading. The court explained that this rule was grounded in the principle that "all investors should have equal access to the rewards of participation in securities transactions."

The Modern Prohibition: Fraudulent Breaches of Duty

The SEC continued to press this "equal access" gloss on Rule 10b-5 through the 1970s. In 1980, however, the Supreme Court rejected the theory in *Chiarella v. United States*. *Chiarella* involved criminal charges against an employee of a financial printer that prepared tender offer documents. Based on those documents, the employee identified companies that were being targeted for takeovers. He then purchased target company shares before bids were announced and later sold those shares for a significant profit. The employee thus traded on the basis of MNPI. He was not, however, an insider of the targeted firms, nor did his employer—which served bidders—have any special relationship with the targets. Despite the absence of such a relationship, the Second Circuit affirmed the employee's conviction for violating Rule 10b-5 based on the equal access theory from *Texas Gulf Sulphur*.

The Supreme Court reversed. In repudiating the equal access theory, the Court reasoned that the nondisclosure of MNPI qualifies as fraud under Rule 10b-5 only when a defendant has an affirmative duty of disclosure. While the Court recognized that the fiduciary relationship between corporate *insiders* and shareholders triggers such a duty, it concluded that the defendant in *Chiarella* did not have a disclosure duty to sellers of the target company securities with whom he had no previous dealings. The Court accordingly reversed the Second Circuit's decision affirming the defendant's conviction.

Chiarella thus did two things. First, it rejected the proposition that Rule 10b-5 creates an expansive parity-of-information regime for securities trading. Second, in endorsing a narrower framework predicated on fiduciary duty and fraud, *Chiarella* effectively ratified what became known as the "classical" theory of insider trading, which is based on an insider's breach of a duty to a *counterparty* (i.e., persons buying or selling the corporation's shares).

Chiarella also left an important question unresolved. While the decision acknowledged that insiders owe disclosure duties to corporate shareholders, the majority declined to consider whether a corporate outsider could violate Rule 10b-5 by breaching duties to *the source of the relevant information* (in *Chiarella*, the defendant's employer and the bidders that had retained it). This alternative basis for Rule 10b-5 liability later came to be called the "misappropriation" theory of insider trading.

In the years following *Chiarella*, lower federal courts split on the validity of the misappropriation theory. The Supreme Court resolved that split in 1997 when it endorsed the misappropriation theory in *United States v. O'Hagan*. In *O'Hagan*, a partner at a law firm representing a takeover bidder bought shares and

options to acquire shares of the target before the bid was announced to the public. Like the defendant in *Chiarella*, the partner could not be held liable under the classical theory of insider trading because he did not owe disclosure duties to the target's shareholders. However, in reversing the lower court's rejection of the misappropriation theory, the Supreme Court held that the partner could be liable under Rule 10b-5 for breaching duties of loyalty and confidentiality *to his law firm and its client*. Those duties, the Court reasoned, precluded the partner from depriving his firm and its client of the exclusive use of their confidential information, which represented a type of property. In the Court's view, the undisclosed misappropriation of that property constituted a form of fraud akin to embezzlement.

Chiarella and *O'Hagan* thus mark the two branches of Rule 10b-5 liability for insider trading. Under the classical theory, corporate insiders violate Rule 10b-5 by trading on the basis of MNPI because such trading breaches a duty of disclosure to their counterparties. Under the misappropriation theory, trading on the basis of MNPI violates Rule 10b-5 if such trading breaches duties to the source of the MNPI.

SEC v. Panuwat: The First "Shadow Trading" Case

The SEC's first shadow trading enforcement action—*SEC v. Panuwat*—concerns the scope of the misappropriation theory of insider trading. The case involves a former employee of Medivation, an oncology-focused biopharmaceutical company. The SEC alleges that, after the employee learned confidential information about a pending acquisition of Medivation, he purchased call options for the stock of another oncology-focused firm, Incyte. After the announcement of Medivation's acquisition, Incyte's stock price increased by roughly 8%, ultimately netting the employee more than $100,000 in profit. The SEC contends that this conduct violated Rule 10b-5 under the misappropriation theory, because Medivation's insider trading policy prohibited employees from using confidential information derived from their employment to trade the securities of other public companies.

In January 2022, a federal district court denied the defendant's motion to dismiss the case. The court concluded that the SEC had adequately alleged that information regarding the acquisition of Medivation was material to Incyte's stock price; that the defendant had breached a duty of confidentiality to Medivation by trading on that information; and that the defendant acted with the requisite mental state. The court also rejected the defendant's argument that the SEC's theory of liability violated the Fifth Amendment's Due Process Clause by failing to give him sufficient notice that his conduct was illegal. While the court acknowledged that no previous cases involved the type of shadow trading at issue in *Panuwat*, it determined that the alleged conduct fell within the established parameters of the misappropriation theory. As a result, the court held that the defendant had adequate notice that the charged conduct was unlawful.

In November 2023, the district court likewise denied the defendant's motion for summary judgment, concluding that the SEC had established genuine disputes of material fact concerning the defendant's receipt of confidential information; the materiality of the information to Incyte's stock; whether the defendant breached a duty to Medivation; and whether the defendant acted with the necessary mental state. A trial is scheduled for March 25, 2024.

Considerations for Congress

Panuwat's implications remain to be determined. The case involves a broadly worded corporate insider trading policy barring the use of confidential information to trade the securities of *any* public company. Moreover, the SEC alleges that the defendant told Medivation's investment bankers that Incyte was an economically similar firm. Without such details, it may be more difficult to prove breach of a duty and that one company's information is material to another company's stock price, which may dissuade the SEC from pushing the misappropriation theory significantly beyond *Panuwat*'s facts.

On the other hand, in denying the defendant's motion for summary judgment, the district court concluded that the SEC had adequately alleged breach of a duty under three independent theories. Two of those theories involve Medivation policies, but the third is rooted in traditional agency principles. The court's decision thus suggests that shadow trading may be unlawful even in the absence of an explicit corporate policy prohibiting it.

Several commentators have argued that this conclusion stretches Rule 10b-5 closer to the type of parity-of-information regime that the Supreme Court rejected in *Chiarella*, especially in cases where the defendant's trading does not appear to harm the source of the relevant MNPI.

This ambiguity may also create challenges for corporate compliance departments. SEC regulations require public companies to disclose whether they have adopted policies and procedures that are "reasonably designed" to promote compliance with insider trading laws. *Panuwat* may have ramifications for this disclosure obligation. If liability for shadow trading turns on the content of a corporation's internal policies, then it appears that such policies can be "reasonably designed" to promote legal compliance even if they do not address shadow trading; silence on the issue would effectively preclude a Rule 10b-5 violation. If, however, shadow trading can violate Rule 10b-5 even without a corporate policy prohibiting it, then public companies may need to prohibit shadow trading explicitly before claiming that they have policies and procedures that are "reasonably designed" to promote compliance with insider trading laws. (Affirmative corporate *authorization* of shadow trading is another possibility; in theory, an employee does not misappropriate his employer's property by using it with permission. That option, however, may not be attractive to image-conscious compliance departments.)

Congress has the power to define the elements of insider trading. Bills in past Congresses aimed to expand and clarify the offense. In the 114th Congress, for example, S. 702, the Stop Illegal Insider Trading Act, would have replaced the current fraud-based system with an equal access regime. Alternatively, Congress could pursue more limited legislation clarifying the legality of shadow trading. Congress also has the option to chart a deregulatory course and leave the regulation of insider trading to private ordering.

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