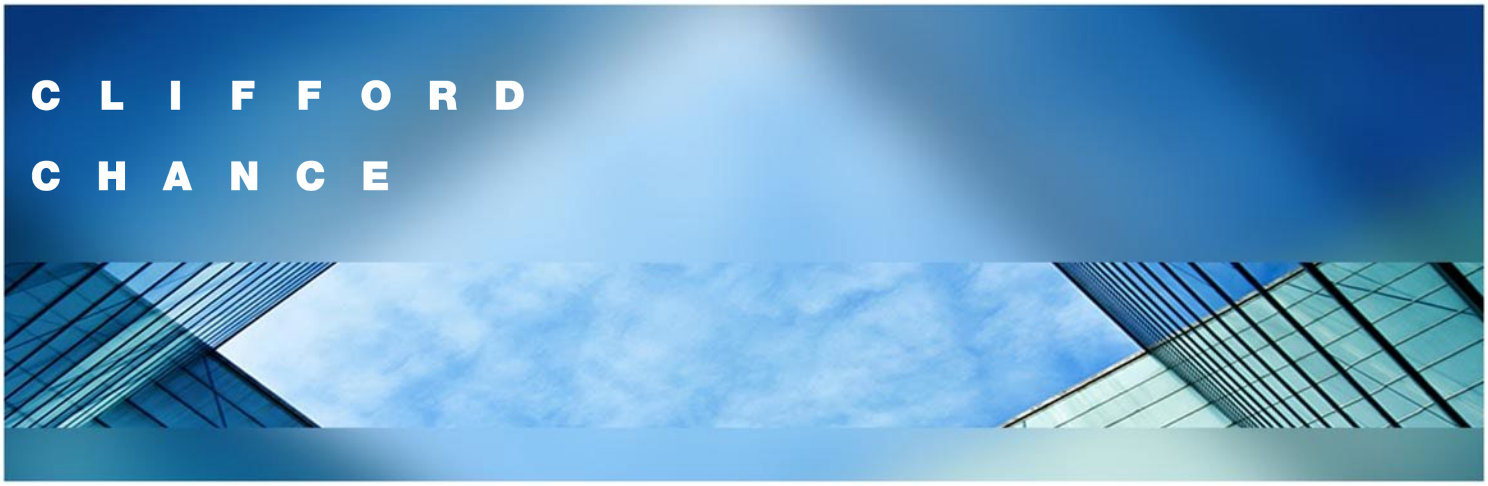

SHADOW TRADING – THE SEC'S NOVEL THEORY OF INSIDER TRADING TO BE TESTED

On August 17, 2021, the United States Securities and Exchange Commission ("SEC") filed a first of its kind insider trading complaint in California federal court, alleging that a former pharmaceutical company executive violated federal securities laws by using inside knowledge that his own company was being acquired, to trade profitably in the securities of a competing company. The complaint suggests that the SEC may attempt to expand the scope of insider trading liability to include a theory a recent academic paper dubbed "shadow trading": where corporate insiders exploit material nonpublic information about their firm, to trade in the securities of an "economically-linked" firm, such as a similarly situated competitor.[1] Such a push from the SEC would almost surely invite serious challenge from accused defendants, and may prompt employers to consider adjustments to their own internal policies to constrain the risk of employee liability under such a theory.

Background

The law against insider trading is derived from the general antifraud provision of the federal securities laws: Exchange Act section 10(b) and Rule 10b-5 thereunder. The law prohibits the trading of a security on the basis of material nonpublic information, in breach of a duty of confidence. The US Department of Justice can pursue criminal penalties for insider trading, while the SEC is empowered to pursue civil claims subject to a lower burden of proof.

The "classical" theory of insider trading arises when a corporate insider trades in the securities of their *own* company, in breach of a duty of confidence owed to the company. By contrast, the far broader "misappropriation" theory of insider

[1] Mihir N. Mehta, David M. Reeb, and Wanli Zhao, Shadow Trading, SSRN, (Sept. 2020), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3689154. A linked firm could include a competitor or a business partner. That article concluded that shadow trading is common – and that it is likely deployed to avoid insider trading law.

trading—upheld by the US Supreme Court in *United States v. O'Hagan*— concerns cases that arise when a third-party (a "corporate 'outsider'") trades in breach of a duty of trust or confidentiality owed to the source of his information.[2] The misappropriation theory expands the scope of insider trading prohibitions by broadly construing the relationship of trust and confidence between a source of material nonpublic information (the "tipper") and a recipient who trades on it (the "tippee").[3]

"Shadow trading" is a novel concept at the outer bounds of the misappropriation theory. The theory is likely to result in challenges in court for the SEC. Those challenges may center on (i) whether a company's internal policies create a duty of trust or confidence under insider trading law that can be breached by trading in another company's securities, (ii) the appropriate "materiality" standard where the information concerns the source company rather than the company whose stock are acquired, (iii) whether the trading was too indirect to constitute trading on material non-public information and (iv) whether deprivation of exclusive use of property must be accompanied by degradation in value to constitute fraud.

The *Panuwat* Case

According to the complaint, Matthew Panuwat, a former executive at Medivation, Inc., allegedly used his knowledge that Medivation was going to be acquired by a major biotechnology company at a "significant premium" to its stock price, to make more than $100,000 by trading in a competing biopharmaceutical company's stock. The complaint alleges that, minutes after learning of the planned deal, Panuwat used his work computer to buy short-dated, out-of-the-money stock options in the competing company.[4] The SEC claims he did so with knowledge the company's acquisition of Medivation would "likely" drive up the stock price of the similarly situated competitor. Indeed, after the acquisition was announced, the competitor's stock price rose 8%, resulting in gains for Panuwat.

The complaint also alleges that Medivation's internal policies expressly forbade the use of confidential information that employees may acquire at Medivation to trade in the securities of any other publicly traded company. The SEC's theory is that Panuwat misappropriated his *employer's* confidential information—about the planned deal with a major biotechnology company— because company policy imposed on Panuwat the duty not to use that information for his own personal gain. The SEC is seeking a permanent injunction, a civil penalty and an officer and director bar. Because they have filed a complaint in federal court, rather than announcing a penalty and resolution, it appears Panuwat plans to fight the charges.

Takeaways

Panuwat's case in some ways may seem like an ideal test case for the SEC's novel "shadow" insider trading theory. The facts would appear to be challenging ones for Panuwat to overcome, at least on the question of whether his trading was based on the confidential information. He traded within minutes of his receipt of the email

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2 *United States v. O'Hagan*, 521 U.S. 642 (1997).

3 The misappropriation is also codified by the SEC in 17 CFR § 240.10b5-2, which states that a duty of confidentiality or trust can arise in three non-exclusive circumstances: (1) when a person accedes to keeping information confidential; (2) when there is a "history, pattern, or practice of sharing confidences" between two parties, causing the person receiving the "material nonpublic information" to know or be aware that there is an expectation of confidentiality between the two parties; and (3) when a party is given confidential, material information from an immediate family member such as a spouse, sibling, parent, or child.

4 Complaint at 7-8, 3:21-cv-06322-SK.

announcing the merger, he made the trades on his work computer, and he purchased instruments long favored by insider traders: short-term options that would have expired without earning money had the stock price remained the same for the duration of the contract, but would have paid off had the price gone up in the near term. However, the question still remains as to whether the SEC will be able to succeed on this "shadow trading" theory, or whether this stretches the misappropriation theory of insider trading too far. There are reasonable arguments that Panuwat's assessment of the potential impact on the rival's share price constitutes market perception based on experience – which is prized rather than penalized.

Panuwat also draws clear parallels with the *Carpenter* case, which set the bar for insider trading violations based on misusing an employer's confidential information.[5] In *Carpenter*, a Wall Street Journal ("WSJ") reporter tipped off a handful of traders prior to publishing his regular "stock picker" column. Such tips not only violated internal WSJ policies, but also constituted insider trading as well as mail and wire fraud. The Supreme Court held that the government did not need to show that WSJ suffered monetary loss from the reporter's scheme; rather, "it is sufficient that the Journal has been deprived of its right to exclusive use of the information, for exclusivity is an important aspect of confidential business information and most private property for that matter."[6]

While the *Carpenter* case is similar to *Panuwat*, there are differences that may be meaningful in the outcome of this latter case. In *Carpenter*, the defendant's act of sharing WSJ's non-public information prior to the publishing of his usual column devalued this information to WSJ's readers; if others were receiving such information before the general public, readers would be less inclined to subscribe to the WSJ or utilize it, thus harming WSJ's reputation and ultimately business. Here, no such analogy can be made. The acquisition still successfully transpired and the price the biotechnology company was going to pay for the acquisition was unaffected by Panuwat's actions. Therefore, a question unanswered by *Carpenter* could soon be laid to rest by *Panuwat* – whether deprivation of the exclusive use of private property amounts to fraud in every instance or if deprivation of exclusive use of property must be accompanied by degradation in value to constitute fraud.

Panuwat's case may signify an increased focus by the SEC on "shadow trading." It will be interesting to see both the outcome of this litigation and to see whether the SEC will seek to expand the principles of this case and bring any enforcement actions where the facts are murkier – in particular, a case where a company does not have a policy prohibiting trading in the stock of other companies based on confidential information about the "source company." Should the inclusion of a policy prove critical to "shadow trading" enforcement efforts, issuers of publicly-traded securities may consider changing their policies to omit the requirement that employees not trade in securities of other companies; these companies may prefer to avoid the reputational damage and management distraction attendant to an insider trading charge against a top executive, especially a charge based on company policy alone. Issuers should monitor this case, and related ones, for further developments.

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5 *Carpenter v. United States*., 484 U.S. 19 (1987).
6 *Carpenter* at 26-27.

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