Rethinking Insider Trading Compliance Policies in Light of the SEC's New "Shadow Trading" Theory of Insider Trading Liability

John P. Anderson

Welcome everyone. I'm very grateful to be here, very grateful to be invited, and very grateful to be part of the business law professor's blog. Working side by side with such distinguished professors from around the country has been a lot of fun for me, and I think it provides an excellent service to the business law community. So, I'm going to try to offer a little bit of education about insider trading law in the United States, and then address one quirky new theory of liability that is percolating – shadow trading. I would like to talk about how we might think about shadow trading, particularly how compliance departments and issuers might address it. So that will be our focus today: insider trading compliance and the problem of shadow trading.

Now, a gentleman named Matthew Panuwat was the head of business development at Medivation, a mid-size biopharmaceutical company, and he learned that Pfizer would acquire Medivation.[1] He also knew that the investment bankers had cited another company, Incyte, as comparable to Medivation. He then did some piecing together and analysis

---

[1] *SEC v. Panuwat*, No. 21-cv-06322-WHO, 2022 WL 633306, *1–2 (N.D. Cal. 2022).

of his own.[2] He anticipated that when the news of his company's, Medivation's, acquisition by Pfizer was announced, it would affect similar companies in their commercial sphere and boost those other companies' value.[3] He reasoned that if a significant control premium is paid for Medivation, then there is a good chance that other companies might also become targets, and that a premium might start getting priced into their stock shares as well.[4]

So, based on this reasoning, Panuwat went out and bought Incyte.[5] His strategy paid off when the acquisition of Medivation by Pfizer was announced.[6] The stock price of Incyte jumped 8%, and he made over a $100,000 in profits.[7] The SEC then came knocking on his door and brought an enforcement action.[8]

Now, before we get back to the story of Panuwat, let me give you a very brief introduction to the law of insider trading in the United States in broad brush strokes. There are lots and lots of tricky aspects and nuances of the law that we are not going to be able to get into in any depth.

---

[2] Id.
[3] Id.
[4] Id.
[5] Id. at 2.
[6] Id.
[7] Id.
[8] Id.

However, we will do a quick introduction to see the lay of the land, and then I want to summarize the basic theory behind the Panuwat case.

In the Panuwat case, the SEC uses the "shadow trading" theory of liability.[9] What I'd like to do is talk about some risks for employers of shadow trading. What is at stake? Why would the SEC care about violations? Moreover, why would the issuers care about their employees engaging in this type of trading based on material, non-public information within the firm? And then finally, with this in place, this kind of weighing of the stakes, I want to talk a little bit about the problems compliance departments will be dealing with should the SEC continue to press this theory of liability in litigation. I will then close by proposing what some would regard as a controversial solution to these compliance problems. I know Tennessee Law's own esteemed professor, Joan Heminway, does not agree with my proposed solution, but let's have some fun with it in the discussion to follow.

So, again, let us begin with a basic introduction to the law of insider trading here in the United States. After the stock market collapse of 1929, the federal government decided that it was time to step in and federalize the regulation of securities trading. Prior to that time, it had been relegated by state law for the most part. So, in the wake of the market

---

[9] Id. at 3.

collapse, several federal statutory systems were embraced, including the Securities Exchange Act of 1934.

Now, our topic is insider trading. The only provision that expressly pertains to insider trading in the 1934 Act is Section 16.[10] And it only focuses on short swing trading, for example, buying or selling within six months of each other, and only for certain insiders defined by the statute.[11] It does not preclude insiders from trading on material non-public information outside the short swing period, and it cannot be enforced by the SEC.[12] Thus, Section 16 is very limited in its scope. Other than Section 16, we have no explicit federal statutory insider trading enforcement regime in the United States. Nevertheless, in 1961 (more than a quarter century after its adoption) SEC Commissioner, William Cary, made it a policy to use other broad catch-all provisions within the 1934 Act to try to cast a wider net in the context of insider trading.[13]

The principal statutory provision that the SEC relied upon was Section 10(b) of the 1934 Act, which is a general anti-fraud provision that makes it unlawful to use any manipulative or deceptive device in connection with the purchase or sale of any security, in contravention of

[10] 15 U.S.C. § 78p(b).
[11] Id.
[12] Id.
[13] *See* JOHN P. ANDERSON, INSIDER TRADING: LAW, ETHICS, AND REFORM 31–37 (2018).

the commission's rules and regulations.[14] In 1961, the SEC brought its first enforcement action pursuant to Section 10(b) in the *Matter of Cady, Roberts, & Co.*[15]

The problem with using a general anti-fraud provision like Section 10(b) to enforce insider trading is that 10(b) says nothing about insider trading.[16] It's not an obvious fit because insiders typically do not affirmatively misrepresent to their counterparties when engaging in their transactions. It can happen, but typically insider trading is done over anonymous exchanges. Think about how you trade stocks today. You get on your e-trade account or whatnot, and you have no interaction with the counterparty to your trade. You make no representations about what you think of the stock that you're purchasing when you engage in the transaction. So, it's not an obvious fit. For there to be fraud in this transaction, it would have to be fraud by silence. Those of you who have taken contracts and torts know that fraud by silence is possible, but it's only triggered where there is a duty to disclose. So, remaining silent typically is not fraudulent unless you have a duty to disclose.

The Supreme Court has recognized two theories under which a trader will have a duty to disclose in the context of insider trading.[17] The

[14] 17 C.F.R. § 240.10b-5 (2022); *see* U.S. v. O'Hagan, 521 U.S. 642, 651 (1997).
[15] Matter of Cady, Roberts & Co., 40 S.E.C. 907 (1961).
[16] 17 C.F.R. § 240.10b-5 (2022).
[17] Chiarella v. U.S., 445 U.S. 222, 230(1980); *O'Hagan*, 521 U.S. at 651–52.

classical theory was first recognized by the Supreme Court in the 1980 case, C*hiarella*.[18] Under this theory, the issuer, its employee, or someone otherwise affiliated with the issuer violates Section 10(b) when he seeks to benefit from trading that firm's shares on the basis of the firm's material non-public information. In such instances, the insider violates a fiduciary or similar duty of trust and confidence to the shareholder (or prospective shareholder) who is the counterparty to the trade. So, think of it something like this: the idea here is that you as an insider of a firm—a CEO, board member, or officer—you have a fiduciary duty to the firm and also to the shareholders. When you receive material non-public information about the firm, there may be multiple owners of that information. The firm owns it, but the shareholders do also, in a loose sense. So, when you use their information against them, if you have a fiduciary relationship to them, that's a form of self-dealing. That's a breach of fiduciary duty. You're using something you hold in trust for them—or that you're taking care of for them—against them.

In other words, in the classical context, the breach of fiduciary duty is to the counterparty to the trade. If you are an insider or firm and you buy your own firm's shares, the person selling those shares is your shareholder. You have a fiduciary duty to them, but you are using

[18] *Chiarella*, 445 U.S. at 230.

information that they do not have access to in order to affect a trade that will profit you and not them—a trade that they would not make if they knew what you know. That's the basic idea behind the classical theory.

The other theory of insider trading liability recognized by the Court is the misappropriation theory. This theory is triggered whether someone is an insider or not. Remember, the classical theory only applies to insiders. The misappropriation theory, however, applies to anyone who seeks to benefit by trading on the basis of material non-public information in violation of a fiduciary or similar duty of trust and confidence to the source of the information. The misappropriation theory says that the duty to disclose is owed to the source of the information, not to the counterparty, effectively covering the rest of the landscape that the classical theory leaves out.

In *United States v. O'Hagan*, the Court first embraced the misappropriation theory of liability that was not raised by prosecutors in time in C*hiarella.*[19] In *Chiarella*, an employee at a print shop learned from the prints he was handling that one company planned to acquire another. Before this information became available to the public, he bought shares in the company to be acquired and profited from the price increase upon subsequent disclosure. Now, you can see how under the classical theory

[19] *O'Hagan*, 521 U.S. at 651–52 (citing *Chiarella*, 445 U.S. at 228).

of insider trading liability, on those facts, there would be no liability because if the person working in the print shop has any fiduciary duty, it's to his or her employer—not the counterparty to the trade.

Sticking with this example, when the print shop worker trades on the information, he's buying shares of another company: not the acquirer, but the company being acquired. He's not, however, employed by the company being acquired.[20] So, when there was an attempt to use a classical theory to impose liability on him in *Chiarella*, the court says, "you can't do that,"[21] because there's no fiduciary duty to the counterparty. So the classical theory would not be able to swoop in and impose liability on that print shop worker.[22] In *O'Hagan*, however, the Court recognized the misappropriation theory of insider trading liability. Under that theory, liability is triggered where *anyone* (insider or outsider) seeks to benefit by trading on the basis of material nonpublic information in violation of a fiduciary or similar duty of trust and confidence to the *source* of that information. The print shop worker would be liable for his failure to disclose his trading on the print shop's confidential information under the misappropriation theory because he would thereby violate his fiduciary duty to his employer. In this way, the classical and misappropriation

---

[20] Id.
[21] *See id.* at 225.
[22] *See id.* at 232–33.

theories are complimentary. The classical theory covers trading based on material nonpublic information in breach of a fiduciary duty by insiders, while the misappriation theory can cover such trading by outsiders as well..

So those are your two basic theories of insider trading liability. Now, what are the penalties? Well, the civil and criminal penalties can be quite significant. Insider trading under Section 10(b) can lead to civil enforcement by the SEC.[23] The consequences can be a permanent or temporary injunction, and disgorgement of trading profits by the trader.[24] This can come with a statutory penalty of treble damages—up to three times the trading profit or loss avoided.[25] Because the SEC can also bring an action for disgorgement, the statutory penalty can then equal four times the trading profits or losses avoided.[26] Note that the treble damage fines can extend directly or indirectly to controlling persons.[27] So firms may also be liable for the insider trading of their employees. Also, there is a possible whistleblower bounty of not less than 10% of the collected monetary sanctions.[28] The SEC cannot bring a criminal action, but they can refer it to the Department of Justice, who can impose on an individual a fine of $5 million and up to 20 years in prison—and for a corporation, a fine up

[23] J. KELLY STRADER ET AL., WHITE COLLAR CRIME: CASES, MATERIALS, AND PROBLEMS 210 (4th ed. 2021).
[24] 15 U.S.C.A. § 78u (West 2021); *see* 15 U.S.C.A. § 78u-1 (West) .
[25] 15 U.S.C.A. § 78u-1(a)(2) (West).
[26] *See* 15 U.S.C.A. §78u(d)(3)(A) (West).
[27] 15 U.S.C.A. § 78u-1(a)(3) (West).
[28] *See* 15 U.S.C.A § 78u-6(b)(1)(A) (West).

to $25 million.[29] These are quite significant penalties, so there is a lot at stake.

Now, we have set the basic structure and lens through which to look at the *Panuwat* case.[30] If Panuwat had purchased Medivation stock directly in advance of the announcement of its acquisition by Pfizer, I hope you can see it would be quite likely he would be liable for insider trading under the classical theory. This is because when Penuwat, who is employed by Medivation, buys shares of Medivation, he would be buying those shares from the Medivation shareholders in breach of a fiduciary duty to those shareholders.[31] He would be using these shareholders' own information against them. So, Penuwat would've been liable under the classical theory if he had profited by purchasing shares in Medivation.

Now, if Penuwat alternatively had profited by purchasing shares of Pfizer in anticipation of its acquisition of Medivation—let us say that for some reason there was an expectation that this is such a good deal for Pfizer, that their stock price would go up as well—then, it's likely he would be liable under the misappropriation theory. I hope you can see why. Here the idea would be that Penuwat would be using Medivation's material non-public information about the pending acquisition to profit from the

---

[29] 15 U.S.C.A. § 78ff(a) (West).
[30] SEC v. Panuwat, No. 21-cv-06322-WHO, 2022 WL 633306 (N.D. Cal. 2022).
[31] *See id.* at *2.

purchase of Pfizer's stock. But Medivation does not want its employees disclosing its material non-public information about this acquisition because it might kill the deal. They're very careful about this—demanding that their employees keep the deal confidential. They do not want this happening. If he disclosed an intent to trade to the the board of directors, they would say, "absolutely not," and they would probably terminate him if he wanted to persist in the trade. So here, in this scenario, his failure to disclose to Medivation before trading would likely incur liability under the misappropriation theory.

Liability under the two two preceding hypothetical scenarios is clear, but, in fact, Panuwat did not trade in either Medivation or Pfizer. He went and bought totally unrelated shares in a totally unrelated company, Incyte, that was not part of this deal at all.[32] So, on the facts of Panuwat, there are certainly no grounds for classical liability for Panuwat with the purchase of the shares of Incyte. He does not owe fiduciary duties to the shareholders of Incyte.

But would there be liability under the misappropriation theory? Well, the first question you might ask when considering liability under the misappropriation theory on these facts might be why would Medivation care about their employees trading in third-party shares? The second

[32] Id.

question would be, had Medivation said something already about what they want their employees to do in these types of situations? Both those questions are relevant to answering the question of whether or not this was a misappropriation of Medivation's information by Panuwat. The SEC's basic theory of liability here, if I understand it, is that Panuwat breached a fiduciary or similar duty of trust and confidence to Medivation under the misappropriation theory by using that company's material, non-public information to profit by trading in Incyte.[33] As evidence of this, the SEC and the district court relied on some language found in Medivation's insider trading compliance policy.[34] Here's the language:

"During the course of your employment . . . with the Company, you may receive important information that is not yet publicly disseminated . . . about the Company…. Because of your access to this information, you may be in a position to profit financially by buying or selling or in some other way dealing in the Company's securities…or the securities of another publicly traded company, including all significant collaborators, customers, partners, suppliers, or competitors of the Company…. For anyone to use such information to gain personal benefit is illegal."[35]

---

33 *See id.* at 3, 5–6.
34 Id. at 6.
35 Id.

Now, that's Medivation's insider trading compliance policy, and the SEC and the district court suggested that this policy, to which Panuwat did agree, is evidence of a duty on the part of Panuwat to Medivation to disclose or abstain from trading in any company's shares based on Medivation's material, non-public information.[36] Consequently, Panuwat's trading in Incyte exposed him to insider trading liability under the misappropriation theory.[37]

Now, when you look at the policy, if he agreed to this, it is fair to suggest that he breached a fiduciary (or at least contractual) duty to Medivation by trading in Incyte's shares.[38] In effect, Medivation told Panuwat in advance, before we give you any of this material non-public information, we want to make something clear: Here's what you can do with it. Here's what you cannot do with it. And if we are going to give it to you, we are only going to give it to you if you agree to these terms, right? Panuwat says, "I agree." Okay, there it is, right? If Panuwat said he agreed while knowing that he would trade anyway, then he's being deceptive, right? And that's the basic idea here. So, the idea here is that Panuwat is liable under the misappropriation theory. And such trading in

---

[36] Id. at 6.
[37] Id.
[38] Id. at 1.

a third party's shares, through economically linked firms, has been dubbed "shadow trading."[39]

Alright, so here are some things that I think are very interesting and a few things that strike me as odd about insider trading liability for shadow trading. Let me just run through them, and I know I'm about to run out of time, and maybe we will have some time during the question period to dig into it a little more deeply. Here are a few things that I want you all to think about. When you look at the insider trading policy of Medivation, it imposes an extremely broad prohibition on its employees' ability to trade. It's not limited to shares of Medivation or companies which Medivation is in privity with, but to *any* other publicly traded company.

Also, it strikes me as interesting that you see in the policy the claim that any such trading in any other publicly trading company's shares based on Medivation's information "is illegal." This is odd language because it is either absolutely false or it is very misleading. The Supreme Court has made it clear that, for example, some such trading may not breach a fiduciary or similar duty of trust and confidence if it is not material. The Court has also made it clear that such trading would not violate Section

39 *See*, Mehta, Mihir N. and Reeb, David M. and Zhao, Wanli, Shadow Trading (September 6, 2020). The Accounting Review, July 2021, Available at SSRN: https://ssrn.com/abstract=3689154.

10(b) insider trading laws if the intent to trade on it is disclosed to the firm in advance. In such cases, even if the firm said "No," then there would be no violation if the employee proceeded to trade because there would be no deception.[40] So, I think the statement that all such trading is illegal is either false or misleading. At a minimum, it is an odd thing to put in a compliance policy, in my view, without giving more support for it.

So those are a couple odd things here. Now, why would Medivation have created this policy? This is a very important question, because the SEC and the district court are leaning on this policy as the trigger for the misappropriation theory of liability in this shadow trading case.[41] It is central to the theory of liability. Why would they have made it so broad? Well, one answer could be that due to the vagueness in the law of insider trading—we did not get into it too much, but there are lots of problems with the law of insider trading in terms of its scope, which is quite ambiguous—Medivation expanded the scope of its prohibition to make sure they stayed on the right side of the law. In other words, out of fear of the stiff penalties, and not quite understanding the law, they decide, okay, let us make it really broad. They may have thought—let's play it safe and prohibit a broad swath of trading by our employees to be certain we are on the right side of the line, and to avoid liability for our employees

[40] 17 C.F.R. § 240.10b-5 (2022); 17 C.F.R. § 240.10b5-1 (2022).
[41] *Panuwat*, 2022 WL 633306, at *3.

and the firm. This way we can be pretty certain our employees will not be engaging in illegal stock trades. That might be one explanation. Another could be that they really contemplated genuine economic risks to the firm by this type of shadow trading. Maybe they were worried that their employees are going to worry too much about trading, rather than doing their jobs. Maybe they were worried that employees would be thinking too much about how they could use confidential information in Medivation to profit from trading in other companies. And that is wasteful. So, it could be one of those things.

But what are the risks of making your entire trading compliance policy so broad? Well, one risk is that the broad policy could really expose Medivation and its employees to a lot of unnecessary liability to the extent that policies are going to be looked at to trigger shadow trading liability. Recall that, under the misappropriation theory (which, as noted above, is the only theory under which Panuwat could be held liable here), trading is only illegal if it is unauthorized by the source. If Medivation had not used the broad language to preclude Panuwat's trading in any other security in its compliance policy, then there would be no basis for liability on these facts. The irony here is palpable because one of the possible reasons for adopting the broad "play-it-safe" policy in the first place was to protect employees and the firm from liability. The risks go beyond the facts surrounding Panuwat where there was an attempt to profit from confidential information.

Think about it. You are an employee at a firm and you just want to buy shares in some other company. You are a high-level employee at Microsoft, and you want to buy shares of Apple to diversify your portfolio. Well, is there going to be any day of the week, or of the year, when you might not, as an employee of Microsoft, have some information that is not public and might be related to Apple? After all—you are in the same industry. Well, if you have a broad trading policy like Medivation's, then any such trade (even if it is to just diversify your portfolio) might be exposing yourself and the firm to liability.[42] Also, there is a problem of materiality. You might think, well, whatever nonpublic information I have about Microsoft company is not material to my purchase of shares in Apple, but the definition of materiality is quite vague, and a jury might decide differently in hindsight. Professor Joan Heminway has written some really good articles on that problem.[43]

What if, instead of the broad compliance policy that Medivation had (that the court and the SEC were focusing on to trigger this

---

[42] Under the SEC's Rule 10b5-1, persons can be liable for trading while "aware" of material nonpublic information—even if that information does not cause the trade.

[43] See, e.g., Joan MacLeod Heminway, Just Do It! Specific Rulemaking on Materiality Guidance in Insider Trading, 72 La. L. Rev. 999 (2012); Joan MacLeod Heminway, Materiality Guidance in the Context of Insider Trading: A Call for Action, 52 Am. U.L. Rev. 1131 (2003).

misappropriation liability), Medivation instead adopted a policy that looked something like the following –"Because of your access to this information, you may be in a position to profit financially by trading in the company's securities or the securities of its customers and suppliers. Such trading is strictly prohibited. Nothing in this policy should, however, be read as prohibiting your trading or dealing in any other issuers' securities, unless expressly restricted by the company (for example, where such trading would jeopardize pending M&A activity, or relates to a tender offer in violation of SEC Rule 14(e)3)."[44] Now, I think that had that language been in Medivation's compliance policy, there's no way the SEC could have brought this case, right? And I think that would certainly be a good thing for Panuwat, but probably good for Medivation as well. So, my time is up and thank you very much.

Professor Anderson:

In many circumstances, with respect to compliance policies, you do want to try to have broader language and adopt a more safe approach. I guess what I am trying to tease out here is that I think it is a really interesting situation—specifically in the context of insider training—tbecause in the attempt to protect the firm and its employees by making the scope of the limitation on trading broader, ironically, the firm arguably

---

[44] 17 C.F.R. § 240.10b5-1 (2022); *see* 17 C.F.R. § 240.10b-5 (2022).

exposes itself to more liability because the firm controls the liability in the misappropriation context. All the firm has to do is say—and the Supreme Court has agreed with this—you are authorized to make these trades, as long as it is not trading in your own company's shares (which would incur classical liability). Under the misappropriation theory, all the source of the information has to do is say that you are authorized in making this trade; such authorization alone avoids Section 10(b) liablity. If the employee says, I am going to do it, then it is not deceptive, And it does not breach a fiduciary duty. It is okay. So, if you control the scope of insider trading liability under the misappropriation theory, then by broadening your restrictions, you are actually exposing yourself to more liability as a firm—not less. And that is just the interesting thing I want to bring out here, because it does not show up in a lot of other compliance contexts, but in this one, it is kind of unique. I know that I sometimes have a way of kind of being controversial to generate discussion. So, I know that probably no firm is ever going to adopt this compliance policy. But regardless, I think firms should take the risks I have identified here seriously and at least be mindful of the fact that by adopting these play-it-safe policies, they may ironically be exposing their shareholders to greater liability.

Professor Anderson:

Yeah, no, I mean, absolutely. I guess I was kind of getting to that. As I pointed out, there are lots of elements in the law of insider trading that are quite vague. One kind of problem in the context of shadow trading is materiality, right? What information about Medivation is material to a trade in Incyte's shares? I pointed out how Professor Heminway has done a lot of really good work in this area about how the materiality standard is problematic. And I think this might be one area where the vagueness could expose, again, a lot of people who are just engaging in quite innocent conduct to insider trading liability.

One thing I did not get into earlier is that the SEC has adopted a rule whereby one's trading simply while aware of material non-public information, even if that information does not cause the trade, (i.e., you did not trade because of the information, but you trade for completely unrelated reason) can be enough to generate insider trading liability. In other words, under this rule (SEC Rule 10b5-1), if you are simply aware of the material non-public information when trading, then they are saying you traded on the basis of it. Now, imagine the application of this rule in the context of shadow trading. So, you're trading in shares of another company for a totally different reason (e.g., portfolio diversification), and yet a jury or fact finder could later discover that you were aware of information that was material to that trade. So you're liable. I mean, this could really balloon into a problem. I'm just curious about how much of this case turns on the existence of a insider trading policy at Medivation—and whether it could have been avoided by a more narrow policy. I guess what I want to say is, if there was no policy at all (or the policy was narrower), what is wrong with Panuwat's simple trading strategy? How does it harm Medivation? Why do they need a policy to cover it? Maybe it is just that you are an employee, generally speaking, you are an agent. You owe a fiduciary duty to your employer. You should not be using the employer's property for personal reasons. Yes. Information is property. But then the SEC seems to have cared a lot about the policy, and I agree the policy supports the SEC's petition—though there is more to it. Even with the policy, Panuwat may not be liable. I think Professor Hemminway may have some interesting things to say about this, right? She and I have had discussions about this. I do not think the policy is required. I agree with you, right? That is, I mean the real argument is, was there a breach of fiduciary, similar duty of trust and confidence—and the policy is more contractual, right?

And there's a big debate as to whether a breach of contract is a breach of fiduciary duty in this context. All I am trying to do is sidestep that altogether because even without the policy, arguably this would have been a breach of fiduciary duty because it's arguably self-dealing using property of the companies for your own personal gain. Totally fair. But if—as we all know, right—the company says that you can do it, then you can do it. So, I guess what I'm saying is the policy can matter to cover the company right here. The company's policy is just one piece of evidence to prove the separate point that there was a breach of fiduciary duty, and the district court bought the argument. Some would argue that that is not right. But what I am saying is if the company explicitly says you can do it in its policy, then I think they (and Panuwat) are covered. In sum, what is clear (at least in my view) is that there would be no liablity for Panuwat if Medivation had adopted my proposed, narrower policy—and that result would have been better for Panuwat, and probably the company.