

Misappropriating the Misappropriation Theory: How the Shadow Insider Theory Allows the SEC to Use Rule 10b5-2 to Impermissibly Expand Its Own Enforcement Power

By Ryan “Shooter” Kemrite*

I. Introduction

Since its creation, the Securities and Exchange Commission (“SEC”) has consistently sought to expand its enforcement authority through innovative theories. To that end, the SEC recently debuted a novel insider trading theory in its prosecution of a pharmaceutical executive, Matthew Panuwat, who used information learned through his employment to trade in the securities of an unrelated company.

This theory, now called shadow insider theory, posits that individuals who “misappropriate” material nonpublic information received from one company and use that information to trade in the securities of another “economically linked” company can be held liable for insider trading. And in April 2024, a jury validated this theory by finding Panuwat liable for insider trading. But more importantly, the SEC’s successful use of this novel theory marks a significant departure from traditional insider trading jurisprudence.

For example, the classical theory of insider trading, as established by the Supreme Court in cases like *Chiarella v. United States* and *Dirks v. SEC*, emphasizes the fiduciary duty owed by corporate insiders and their tippees to the shareholders of the company whose securities are traded. The misappropriation theory, endorsed in *United States v. O’Hagan*, broadened the scope to include “outsiders” who misappropriate confidential information in breach of a duty of trust and confidence owed to the source of the information. Yet the shadow insider trading theory piggybacks off the misappropriation theory to extend liability further, capturing trading activities that do not directly harm the shareholders of the source company or involve a traditional fidu-

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ciary breach. This expansion raises critical legal and policy questions about the limits of the SEC's enforcement authority and the underlying principles of insider trading law.

The most troubling takeaway from the Panuwat prosecution is that the SEC successfully established Panuwat's duty of trust and confidence to his employer through different contracts like a confidentiality agreement. The SEC did so by relying on Rule 10b5-2(b)(1), which purports to impose a "duty of trust or confidence" for purposes of the 'misappropriation' theory of insider trading "whenever a person agrees to maintain information in confidence."¹ This article argues that is impermissible.

Following this introduction, this article summarizes the insider trading legal framework. Next, the Panuwat case will be detailed. Lastly, this article will argue that Shadow Insider Theory, coupled with Rule 10b5-2, is an impermissible expansion of the SEC's enforcement powers.

II. Overview of the Legal Framework for Insider Trading

As a brief overview, the SEC's "catchall" antifraud provision is Section 10(b) of the Securities Exchange Act of 1934, which creates fraud liability for conduct involving a "deceptive device or contrivance" used "in connection with" the purchase or sale of securities.² Section 10(b), however, is not self-executing.³ So in 1942, the Commission promulgated the point to Section 10(b)'s spear: Rule 10b-5.⁴

Relevant here, Rule 10b-5 makes it unlawful:

(a) To employ any device, scheme, or artifice to defraud, [or]

. . .

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.⁵

Insider trading was first deemed a "deceptive device," thus falling under Section 10(b)'s and Rule 10b-5's ambit, in the SEC's 1961 administrative opinion, *In re Cady, Roberts & Co.*⁶ The SEC's reasoning in *Cady Roberts* was soon adopted by the federal courts, most notably by an en banc Second Circuit in *SEC v. Texas Gulf Sulphur Co.*⁷ The *Texas Gulf Sulphur* opinion laid out what is now commonly known as the "abstain or disclose rule":

"anyone in possession of material inside information must either disclose it to the investing public, or, if he is disabled from disclosing it in order to protect a corporate confidence, or he chooses not to do so, must abstain from trading in or recommending the securities concerned while such inside information remains undisclosed."⁸

Put simply, the abstain or disclose rule imposed a duty on "insiders" with access to material, nonpublic information to ei-

ther disclose that information to the public before trading on it or abstain from trading altogether. So the critical determination under this rule was who is an “insider” subject to this rule.

The *Texas Gulf Sulphur* court, and many courts after it, used “the parity of information doctrine to identify insiders subject to the abstain or disclose rule.”⁹ The rationale behind the parity of information doctrine was simple: “all investors should have equal access to information that a reasonable investor would consider material to investment decisions, and that any trade in which only one party had an opportunity to learn and did learn such information is inherently unfair.”¹⁰ Thus, “anyone who, trading for his own account in the securities of a corporation has ‘access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone’ may not take ‘advantage of such information knowing it is unavailable to those with whom he is dealing,’ i.e., the investing public.”¹¹

This parity of access to information approach to insider trading is still followed by most developed securities markets outside the United States.¹² The United States, however, does not, thanks to the Supreme Court’s rejection of this broad approach for a more restrained fiduciary analysis in *United States v. Chiarella*.

A. The Classical Theory of Insider Trading

The facts from *Chiarella* are straightforward: Vincent Chiarella, by virtue of his employment with a financial printing company, deduced the targets of five corporate takeovers from information to be printed by his employer.¹³ Chiarella then traded on and profited from this material, nonpublic information, which drew the Commission’s ire, resulting in his conviction on 17 counts of violating Section 10(b) and Rule 10b-5.¹⁴ On appeal, the Second Circuit affirmed the conviction, reasoning that Chiarella was a “quasi-insider” because his employment provided him with “regular access to market information.”¹⁵ So even though he not was not an employee of the issuer in whose securities he traded, the Second Circuit held Chiarella was subject to the abstain or disclose rule.¹⁶

Yet the Supreme Court unequivocally rejected the parity of information approach, reasoning that simply trading on material, nonpublic information is “not a fraud under § 10(b)” unless the trader is under a duty to disclose.¹⁷ And “a duty to disclose under § 10(b) does not arise from the mere possession of nonpublic market information.”¹⁸ Rather, a duty to disclose arises only if based on “a specific relationship between two parties” such as a fiduciary relationship or one of “trust and confidence.”¹⁹ So because Chiarella owed no duty to the sellers of the target company’s se-

curities he bought—“[h]e was not their agent, he was not a fiduciary, he was not a person in whom the sellers had placed their trust and confidence”—Chiarella’s convictions under Section 10(b) and Rule 10b-5 were reversed.²⁰

Post-*Chiarella*, the Supreme Court soon expanded its fiduciary analysis to “temporary insiders” and tippees in “tipper-tippee” situations. For instance, in *Dirks v. S.E.C.*, the Court addressed a situation where a corporate insider (the tipper) provided material, nonpublic information to an unaffiliated third party (the tippee).²¹ There, the Commission’s tipper-tippee argument was the tippee “inherits” the tipper insider’s fiduciary duty to shareholders when the tippee has received inside information.²² The *Dirks* Court, however, rejected that argument.²³

Yet in doing so, the Court laid out two key points. First, tippee liability attaches only when an “insider has breached his fiduciary duty to the shareholders by disclosing the information to the tippee and the tippee knows or should know that there has been a breach.”²⁴ And second, outsiders like attorneys, accountants, consultants, and others, who have a duty to keep confidential nonpublic information that is disclosed them by the corporation, can become temporary fiduciaries of that corporation.²⁵

In short, *Chiarella* and its progeny embody the “classical” approach to insider trading, which, in succinct terms, prohibits corporate fiduciaries and temporary insiders “from trading while aware of material non-public information because these persons have a relationship of trust and confidence to the shareholders of the subject corporation.”²⁶ Trading on such information is what qualifies as a “deceptive device” under Section 10(b).²⁷

B. The Misappropriation Theory

The “classical” approach to insider trading, however, represented a far less expansive view than the now-rejected parity of access approach. *Chiarella*’s focus on the duty owed to the subject corporation or its shareholders had limited the types of defendants who could be pursued for insider trading violations.²⁸ So to re-expand the scope, the SEC began aggressively pursued the creative insider trading theory it had raised as an alternative in *Chiarella*: the misappropriation theory.²⁹

In its 1997 decision, *United States v. O’Hagan*, the Supreme Court adopted the misappropriation theory, holding that a trader commits securities fraud “when he misappropriates confidential information for securities trading purposes, in breach of a duty owed to the source of the information.”³⁰ In other words, a trader’s undisclosed use of material, nonpublic information that is the property of the source breaches “a duty of loyalty and confidenti-

ality” by “defraud[ing] the principal of the exclusive use of that information.”³¹ Thus, “misappropriation” of material nonpublic information to trade in the marketplace constitutes a “deceptive device” used “in connection with” securities transactions in violation of Section 10(b), violating a duty of trust and confidence.³² Yet unlike under the classical approach, which “targets a corporate insider’s breach of duty to shareholders with whom the insider transacts,” the misappropriation theory focuses on the use “of nonpublic information by a corporate “outsider” in breach of a duty owed not to the party on the other side of the transaction, but to the source of the information.

The *O’Hagan* Court did, however, leave an easy way out: “if the fiduciary discloses to the source that he plans to trade on the nonpublic information, there is no ‘deceptive device’ and thus no § 10(b) violation.”³³

III. Shadow Insider Theory

The misappropriation theory for insider trading casts a broad net. Yet that has not stopped the SEC from advancing other novel theories to expand the scope. One such theory, known as “shadow insider theory,” posits that individuals who possess material nonpublic information about one company (the source company) and use that information to trade in the securities of another “economically linked” company (a shadow company) can be held liable for insider trading.³⁴ And in April 2024, this novel theory became a reality thanks to the SEC’s successful enforcement action against Matthew Panuwat in the Northern District of California.

A. *SEC. v. Panuwat: The Underlying Facts*

In 2016, Panuwat worked as a Senior Director of Business Development for a publicly traded, mid-sized biopharmaceutical company named Medivation Inc.³⁵ At that time, Medivation had engaged investment bankers to help determine whether it would be better for Medivation to be acquired or merge with another company.³⁶ Panuwat worked with the bankers throughout this process, discussing with them other companies that were comparable to Medivation in the bio pharmaceutical industry based on size, profitability, and other characteristics.³⁷

On August 18, 2016, Medivation’s CEO emailed Panuwat to inform him that Medivation had struck a deal to be acquired by pharmaceutical giant Pfizer at a significant premium to Medivation’s current share price.³⁸ Knowing a public announcement was imminent, and mere minutes after receiving this email, Panuwat purchased out-of-the-money call options for Incyte Corporation, a competitor and comparable mid-sized biopharmaceutical company.³⁹ Panuwat told no one at Medivation he was purchasing

these options.⁴⁰

According to the SEC, Panuwat believed that Incyte's stock price would jump after Medivation's acquisition was announced. Panuwat's hunch was right. After Medivation announced it was to be acquired by Pfizer at a 21.4% premium its current share price, Medivation's shares jumped. But so did Incyte's, which netted Panuwat over \$107,000 in profits.⁴¹

B. *SEC v. Panuwat*: The SEC's Enforcement Theory.

The SEC's single insider trading claim was simple: Panuwat misappropriated material nonpublic information from his employer in violation of Section 10(b) and Rule 10b-5. To that end, the SEC needed to prove Panuwat owed a duty of trust and confidence to Medivation and breached that duty by knowingly trading on material nonpublic information that he had learned through his employment with Medivation.⁴² So the key threshold for the SEC was establishing Panuwat owed Medivation a duty of trust and confidence.

The SEC sought to do so in three ways. First, the SEC pointed to Medivation's insider trading policy that Panuwat was subject to as part of his employment. This insider trading policy prohibited Panuwat from using material nonpublic information learned through employment to trade in "the securities of another publicly-traded company, including all significant collaborators, customers, partners, suppliers or competitors of the Company, or to disclose such information to a third party who does so."⁴³

Second, the SEC highlighted Medivation's confidentiality agreement, which required Panuwat "to refrain from using Medivation's confidential information for his own personal benefit."⁴⁴ And lastly, the SEC claimed Panuwat had a duty to not misappropriate Medivation's confidential information under general agency law principles.⁴⁵

In denying Panuwat's motion for summary judgment, the district court's reasoning was not very illuminating. Indeed, for all three potential "duties," the *Panuwat* Court's reasoning was essentially the same: "When considered in a light that is most favorable to the SEC, the facts could support a jury finding that Panuwat (a) owed Medivation a duty of confidentiality and trust that arose when he signed the Confidentiality Agreement, (b) obtained confidential information about Medivation's sale process in the Hung Email, and (c) exploited that information for his personal benefit when he bought Incyte stock options seven minutes after reading the email, and later sold those options for a profit."⁴⁶ There was no discussion on whether the shadow insider theory exceeded the scope of the SEC's enforcement authority.

C. SEC v. Panuwat: The Jury Finds Panuwat Liable for Insider Trading.

After Panuwat's motion for summary judgment was denied, the case proceeded to trial on March 25, 2024.⁴⁷ After seven days of trial, the jury was instructed that, to find Panuwat liable for insider trading, "the SEC must prove each of the following elements by a preponderance of the evidence:

1. That the Defendant owed a duty of trust, confidence, or confidentiality to his employer, Medivation;
2. That, as a result of his relationship with Medivation, the Defendant possessed nonpublic information that was material to Incyte;
3. That the Defendant bought Incyte call options on the basis of that information and in a breach of duty owed to Medivation; and
4. That the Defendant, at the time he bought Incyte call options, knew that the information he received from Medivation was both nonpublic and material to Incyte or acted recklessly as to whether the information was both material and nonpublic, and knew that, or acted recklessly as to whether, he lacked consent from Medivation to use the information."⁴⁸

What's more, the jury instructions outlined that: "an employee has a duty of trust, confidence, or confidentiality with regard to nonpublic information when he expressly agrees to maintain the confidentiality of his employer's nonpublic information or to refrain from using that information for personal gain. A duty also arises, even in the absence of a written agreement, when an employer entrusts an employee with confidential information."⁴⁹

The jury deliberated for just over two hours, returning a verdict finding Panuwat liable for one count of insider trading under the misappropriation theory.⁵⁰

IV. The Shadow Insider Theory is an Improper and Impractical Expansion of the Misappropriation Theory

The most obvious point that makes the shadow insider theory from *Panuwat* such a notable expansion under the misappropriation theory is that it—for the first time—allows the SEC to capture those trading in the securities of companies *other than* the source of the information. For instance, Panuwat did not trade in either Medivation's or Pfizer's stock. Rather, he traded in the securities of a third company, Incyte.⁵¹ The shadow insider theory then, creates fraud liability for "outsiders" trading on material nonpublic information in the securities of some other "economically linked" company.

On one hand, it's a logical expansion for the SEC; the "animating purpose of the Exchange Act" is "to insure honest securities

markets and thereby promote investor confidence.”⁵² And unlike private plaintiffs, the SEC need not prove loss causation in its enforcement actions, which opens up a myriad of opportunities for the SEC to expand its purpose. On the other hand, making economic loss so attenuated from the “deceptive device” through the shadow insider theory reads more like imposing on traders a duty to all investors in the market (parity of information approach), which the Supreme Court has expressly disavowed.⁵³ Likewise, it makes it more apparent that the misappropriation theory is not punishing a fraudulent securities transactions, but the deprivation of the principal’s “exclusive use” of material nonpublic information.⁵⁴ So short of requiring the SEC to prove an economic loss in the marketplace caused by said “misappropriation,” this problem will only exacerbate because the shadow insider theory is well-founded under *O’Hagan’s* misappropriation reasoning.

But beside the complete separation of financial injury in a securities transaction from the “deceptive device,” a large problem with the shadow insider theory is how it contorts the ways that the SEC can establish a duty of trust and confidence.

A. Liability Under Section 10(b) Cannot Be Based Solely on an Agreement to Maintain Information in Confidence

Although the SEC sought to establish a duty of trust and confidence in the *Panuwat* case in three ways, the most concerning was through a specific type of contract—Medivation’s confidentiality agreement with Panuwat.⁵⁵ To do so, the SEC relied on Rule 10b5-2, which purports to provide “a non-exclusive definition of circumstances in which a person has a duty of trust or confidence for purposes of the ‘misappropriation’ theory of insider trading.”⁵⁶ And relevant to the *Panuwat* case, subsection (b)(1) imposes a duty of trust or confidence “whenever a person agrees to maintain information in confidence.”⁵⁷

Historically, courts have allowed the SEC to use subsection (b)(1) to impose a duty of trust and confidence. One such example is the Second Circuit’s 2021 decision in *United States v. Chow*. There, the court affirmed the defendant’s criminal insider trading convictions, holding that the nondisclosure agreement that the defendant signed was sufficient to impose a duty of trust or confidence under the misappropriation theory.⁵⁸ Yet in reaffirming Rule 10b5-2(b)(1)’s validity the *Chow* court (and the *Panuwat* court) failed to grapple with several key points.⁵⁹

i. The SEC Promulgated Rule 10b5-2 Only to Address Duties of Trust and Confidence in Family or Personal Relationships.

For one thing, Rule 10b5-2 was never meant to apply to busi-

ness relationships like employment. Indeed, the proposed rule stated that “Rule 10b5-2 addresses the issue of when a breach of a family or other non-business relationship may give rise to liability under the misappropriation theory of insider trading.”⁶⁰ Likewise, the analysis in the final rule focuses exclusively on “family or personal relationships,” stating, for example, that “there is good reason for the broader approach we adopt today for determining *when family or personal relationships* create “duties of trust or confidence” under the misappropriation theory.”⁶¹ In fact, the SEC’s clear position at the time was that it was only “providing more of a bright-line test for certain enumerated close family relationships.”⁶² So by applying Rule 10b5-2(b)(1) outside family or personal relationships, the SEC is exceeding the rule’s stated scope, applying the rule in way the public did not provide any comment on.⁶³

ii. *The SEC’s Use of Rule 10b5-2(b)(1) Exceeds its Statutory Authority and the Supreme Court’s Interpretation of Section 10(b)*

Another point seemingly overlooked in *Chow* and *Panuwat* is that even if the SEC had intended it to apply the rule in non-familial circumstances like an employee’s confidentiality agreements, Rule 10b5-2’s text expands the misappropriation theory past the Supreme Court’s interpretation of Section 10(b)’s scope. For instance, in *O’Hagan*, the Court held that violating a duty of “trust *and* confidence” is what constituted a “deceptive device” under Section 10(b).⁶⁴

Yet Rule 10b5-2 outlines circumstances in which a person has a duty of “trust *or* confidence,” like when “a person agrees to maintain information in confidence.”⁶⁵ A plain reading of subsection (b)(1) then regulates outside the Supreme Court’s direction in *O’Hagan* by creating liability under the misappropriation theory based solely on a duty of confidence. In other words, Rule 10b5-2(b)(1) makes it so that the existence of a fiduciary-like relationship of “trust *and* confidence” is *not* necessary to find a “deceptive device” under Section 10(b). That interpretation would impermissibly extend the SEC’s authority beyond the conduct that the Supreme Court has held is encompassed by Section 10(b)’s prohibition.⁶⁶

In the past, however, some courts like the Second Circuit in *Chow* have permitted the SEC to deem the breach of an agreement to maintain information in confidence a “deceptive device” under Section 10(b) by deferring to the Commission’s interpretation based on the Supreme Court’s decision in *Chevron v. Natural Resources Defense Council*.⁶⁷ In short, *Chevron* stated that, if the statute was ambiguous, courts should defer to an agency’s inter-

pretation if it “is based on a permissible construction of the statute” and “a reasonable policy choice for the agency to make.”⁶⁸ So because the SEC’s interpretation of Section 10(b) through Rule 10b5-2(b)(1) was considered “a reasonable policy choice,” courts generally upheld its use to establish a duty of trust or confidence for the misappropriation theory.⁶⁹

But after the Supreme Court’s recent decision in *Loper Bright Enterprises*, deference to agency interpretation under *Chevron* is no longer the status quo.⁷⁰ In rolling back *Chevron*’s differential reasoning to agency rulemaking, the *Loper* Court held, “*Chevron* is overruled. Courts must exercise their independent judgment in deciding whether an agency has acted within its statutory authority, as the APA requires.”⁷¹ So courts can now decide, with no obligatory deference, whether the SEC’s interpretation goes too far. And based on the plain text, it appears clear that using Rule 10b5-2(b)(1) to impose a duty of trust or confidence—such that a violation of that duty constitutes a “deceptive device” under Section 10(b)—is clearly outside the SEC’s statutory authority.

iii. Confidentiality Agreements Do Not Create a Fiduciary Relationship

Yet even if Rule 10b5-2(b)(1) applied to business relationships, and even if not outside the scope of the SEC’s regulatory authority, confidentiality agreements alone do not form a fiduciary or fiduciary-like relationship of “trust *and* confidence” because the relationship is contractual.⁷² Indeed, “while a fiduciary relationship or confidential relationship may arise from the circumstances of a particular case, to impose such a relationship in a business transaction, the relationship must exist prior to, and apart from the agreement made the basis of the suit.”⁷³ And as courts across the country, have consistently recognized, “[a] breach of the confidentiality provisions . . . would give rise to a breach of contract claim, not a breach of fiduciary duty claim.”⁷⁴ Yet both the *Chow* and *Panuwat* courts accepted a contrary proposition without much scrutiny.

iv. Rule 10b5-2(b)(1) Creates Fraud Liability Even If the Material Nonpublic Information is Maintained In Confidence.

One last point overlooked in *Chow* and *Panuwat* is that creating fraud liability under Section 10(b) based solely on an agreement to maintain certain information in confidence under subsection (b)(1) doesn’t make sense because a person can still trade on material nonpublic information without breaching confidentiality. Take the facts from the SEC’s unsuccessful prosecution of Mark Cuban, for example. There, in early 2004, the CEO of Mamma.com called Cuban, who held a 6.3% stake in the company, to inform Cuban that Mamma.com would be raising capital through a PIPE

offering.⁷⁵ According to the SEC, “[t]he CEO prefaced the call by informing Cuban that he had confidential information to convey to him, and Cuban agreed that he would keep whatever information the CEO intended to share with him confidential.”⁷⁶

Cuban was not happy, however, with how the PIPE offering would dilute his holdings. Thus, that same day, after gathering more information from the investment bank conducting the PIPE offering, Cuban directed his broker to sell his entire stake in Mamma.com.⁷⁷ And because Cuban sold his stock before Mamma.com publicly announced the offering—which caused the stock to plummet—Cuban avoided over \$750,000 in losses.⁷⁸

One of the SEC’s theories was that Cuban had a duty of trust and confidence to not trade on the material nonpublic information because he had orally agreed to maintain that information in confidence as described in Rule 10b5-2(b)(1).⁷⁹ Cuban did, of course, trade on the information that Mamma.com would be conducting a PIPE offering. But the SEC did not allege that he had agreed to abstain from trading.⁸⁰ And there were no allegations Cuban broke confidentiality because, as the district court in the case reasoned, “[a] person who receives material, nonpublic information may in fact preserve the confidentiality of that information while simultaneously using it for his own gain.”⁸¹ Yet that did not stop the SEC in *Cuban* and *Panuwat*, nor the Department of Justice in *Chow* from trying to use a confidentiality agreement—that had not been breached—to generate a duty of trust and confidence.⁸²

In sum, despite the reaffirmation of Rule 10b5-2 in *Chow* and *Panuwat*, using subsection (b)(1) to impose a duty of trust or confidence is contrary to the Supreme Court’s reasoning in *O’Hagan*, turns confidential, contractual relationships into fiduciary ones, even if there’s no breach, and, without the deferential shadow of *Chevron*, exceeds the SEC’s statutory authority.

B. Practical Compliance Problems With the Shadow Insider Theory.

Beside the above, the practical implications of using a contractual relationship like a confidentiality agreement to establish a duty of trust and confidence under the shadow insider theory is likely untenable. Panuwat did, of course, agree to refrain from trading in his confidentiality agreement.⁸³ That said, practical problems will still arise from allowing companies to weaponize contracts that cover trading in the securities of “economically linked” companies.

One such practical problem, as an amicus brief in *Panuwat* pointed out, is how the weaponization of contracts under the shadow insider theory would allow large companies to manipu-

late the marketplace. For example, the arguments advanced by the SEC in *Panuwat* would allow a company to use contracts with its employees to restrict its employees from trading in the stock of “‘significant collaborators, customers, partners, suppliers, or competitors’ *unless it benefited the company.*”⁸⁴ If true, the next logical step is that a publicly traded company could then seek to keep the price of a competitor’s securities artificially low by barring its employees from trading in the competitor’s stock.⁸⁵ And that would be permissible.

Take the scenario in *Panuwat*: the SEC agreed that Incyte’s stock price was artificially low in the days before Medivation’s acquisition was announced.⁸⁶ And Incyte was Medivation’s competitor.⁸⁷ So simply put, “Medivation had the power to both keep its competitor’s stock price artificially low by restricting Medivation’s employees from ‘pushing’ Incyte’s share price in the right direction by purchasing shares and, *sua sponte*, the power to impose potential civil regulatory and/or criminal liability for its employees who fail to comply, all with the SEC’s support.”⁸⁸ In short, the SEC helping large companies artificially deflate the price of a competitor’s securities hurts, not helps, ensuring a healthy securities market.

What’s more, the opposite can also happen—the shadow insider theory allows a company to potentially reward employees with material nonpublic information. Indeed, as Justice Thomas’s concurrence in *O’Hagan* aptly noted, because any duty to abstain from trading can be discharged if the source knows the recipient plans to trade on the nonpublic information, “were the source expressly to authorize its agents to trade on the confidential information—as a perk or bonus, perhaps—there would likewise be no § 10(b) violation.”⁸⁹ And when “authorized,” an “outsider” like *Panuwat* “would still be trading based on nonpublic information that the average investor has no hope of obtaining through his own diligence.”⁹⁰ Again, not really the hallmark of a healthy securities market.

Venture capital firms can also come under the insider trading scope as most large firms are carrying publicly traded equities along with their startup investments. For example, according to Tiger Global Management’s latest 13F filing, the firm owns nearly a billion dollars of Nvidia stock.⁹¹ And it would be hard to promise that Tiger’s confidential due diligence into private venture companies would not be somehow informing its activity in the public markets.⁹² Likewise, the opposite could be true: material nonpublic information that Tiger Global Management learns through its position as a large shareholder in publicly traded companies would be informing its investment decisions in the startup space.

And why stop at employees, business partners, or venture investments? Why not consumers? Imagine if a consumer contract, say Alaska Airlines' ticketing agreement, required the passenger to maintain in confidence information like any mechanical failures that occurred during the flight. And then say, after a door on an Alaska Airlines plane made by Boeing falls off mid-flight, a passenger, before that information becomes public, buys put options for Boeing stock. Boeing's stock then drops 7% when the news is released, netting the passenger a pretty penny.⁹³

The passenger had, however, agreed to keep information about any mechanical failures confidential and not trade on it. Under the shadow insider theory and Rule 10b5-2(b)(1), the SEC could pursue that passenger for "insider trading" in Boeing stock because the passenger supposedly had a duty of trust and confidence to Alaska Airlines through their ticketing agreement. Ridiculous, for sure, but that is what shadow insider/Rule 10b5-2 combination allows for.

V. Conclusion

The shadow insider trading theory represents a significant and potentially problematic expansion of insider trading liability. Suggesting that individuals who possess material nonpublic information about one company and use that information to trade in the securities of another "economically linked" company can be held liable for insider trading based on contractual relationships makes it so that wide swathes of normal trading activity now qualifies as fraudulent. And while this approach may seem to align with the SEC's mandate to ensure fair and honest markets, it raises several critical legal and policy concerns that merit closer examination.

On the legal front, relying on Rule 10b5-2 to establish a duty of "trust *or* confidence" exceeds the Supreme Court's reasoning that insider trading liability must be premised on a violation of "a fiduciary or similar relationship of trust *and* confidence."⁹⁴ What's more, judicial deference to the SEC's interpretation of what constitutes a "deceptive device" under Section 10(b) is no longer mandatory thanks to the Supreme Court's decision in *Loper Bright Enterprise*. So courts must now exercise independent judgment to scrutinize whether the SEC's novel enforcement theories are even within its statutory authority—something that is surprisingly absent from the *Panuwat* court's reasoning.⁹⁵

Likewise, the SEC should take this post-*Chevron* moment to do three things. First, the SEC should carefully reevaluate Rule 10b5-2(b)(1) and its application in cases like *Panuwat* to ensure that its enforcement actions align with the legislative intent and judicial precedents governing insider trading. Second, the SEC could also consider revising Rule 10b5-2 to more explicitly define

the types of relationships and agreements that create a duty of trust and confidence and clearly state whether the rule applies to business relationships. This clarification would provide greater legal certainty and help market participants understand the scope of their obligations.

Lastly, the SEC should limit the application of the shadow insider trading theory to scenarios where there is a clear and direct connection between the material nonpublic information and the traded securities. In other words, the “deceptive device” should be limited to the trading in the securities of the source of the material nonpublic information. But if the SEC chooses not to make these adjustments, the courts will need to take corrective action.

And on the policy front, the potential for companies to manipulate these restrictions for competitive advantage, as highlighted by Justice Thomas in *O’Hagan* and the amici the *Panuwat* case, underscores the need for clear and consistent legal standards that prevent abuse and ensure fair enforcement. For instance, using subsection (b)(1) blurs the lines between contractual obligations and fiduciary duties and at best, unduly pressures companies to scrutinize and restrict their employees’ trading activities, even when such activities do not involve direct misuse of the company’s information. And at worst, it creates perverse incentives for large companies. Likewise, because *O’Hagan* allows a surprisingly easy escape from insider trading liability—there’s no “deceptive device” if the source of the material nonpublic information knows the recipient will trade on that information—some forms of “insider trading” will go unpunished.⁹⁶ Thus, without clear guidelines or limitations, market participants will likely endure compliance nightmares.

In sum, the shadow insider theory has impermissibly expanded the scope of insider trading liability beyond traditional boundaries. Not only does this novel theory pose compliance problems in the real world, but it also raises questions about the fairness and appropriateness of such an expansive interpretation of securities laws. If the SEC is truly concerned with promoting investor confidence, it must act now to rein in the expansive implications of the shadow insider theory.⁹⁷

NOTES:

¹17 C.F.R. § 240.10b5-2(b)(1) (emphasis added).

²15 U.S.C.A. § 78(j)(b).

³See *Id* (making unlawful conduct that contravenes “such rules and regulations as the Commission may prescribe”).

⁴§ 240.10b-5.

⁵*U.S. v. O'Hagan*, 521 U.S. 642, 651, 117 S. Ct. 2199, 138 L. Ed. 2d 724, Fed. Sec. L. Rep. (CCH) P 99482, 191 A.L.R. Fed. 747 (1997) (citing 17 C.F.R. § 240.10b-5).

⁶*Matter of Cady, Roberts & Co.*, 40 S.E.C. 907, Release No. 34, 6668, Release No. 6668, 1961 WL 60638 (S.E.C. Release No. 1961).

⁷*SEC v. Tex. Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968) (en banc) cert. denied, 394 U.S. 976 (1969).

⁸*Id.* at 848.

⁹Ebaugh, Insider Trading Liability for Tippers and Tippees: A Call for the Consistent Application of the Personal Benefit Test, 39 TEX. J. BUS. LAW. 265, 272 (2003).

¹⁰*Dirks v. S. E. C.*, 681 F.2d 824, 835, Fed. Sec. L. Rep. (CCH) P 98669 (D.C. Cir. 1982), judgment rev'd, 463 U.S. 646, 103 S. Ct. 3255, 77 L. Ed. 2d 911, Fed. Sec. L. Rep. (CCH) P 99255 (1983).

¹¹*Tex. Gulf Sulphur Co.*, 401 F.2d at 848 (quoting *Matter of Cady, Roberts & Co.*, 40 S.E.C. 907, 912, Release No. 34, 6668, Release No. 6668, 1961 WL 60638 (S.E.C. Release No. 1961)).

¹²See Marc. Steinberg, Rethinking Securities Law 214 n.22 (Oxford University Press 2022) (noting that the European Union and Australia follow the parity of information approach, while Canada and China follow the access approach).

¹³*Chiarella v. U. S.*, 445 U.S. 222, 224, 100 S. Ct. 1108, 63 L. Ed. 2d 348, Fed. Sec. L. Rep. (CCH) P 97309 (1980).

¹⁴*Id.* at 225.

¹⁵*United States v. Chiarella*, 588 F.2d 1358, 1365–66 (2d Cir. 1978).

¹⁶*Id.* at 1366.

¹⁷*Dirks v. S.E.C.*, 463 U.S. 646, 654, 103 S. Ct. 3255, 77 L. Ed. 2d 911, Fed. Sec. L. Rep. (CCH) P 99255 (1983) (citing *Chiarella v. United States*, 445 U.S. 222, 233, 237, 238–39, 239–40 (1980)).

¹⁸*Chiarella*, 445 U.S. at 230

¹⁹*Id.* at 230–33.

²⁰*Id.* at 232–33.

²¹*Dirks*, 463 U.S. at 648–49.

²²*Id.* at 655.

²³*Id.* at 665–67.

²⁴*Id.* at 660.

²⁵*Id.* at 655, n.14.

²⁶See Marc. Steinberg, Rethinking Securities Law 215 (Oxford University Press 2022).

²⁷*U.S. v. O'Hagan*, 521 U.S. 642, 652, 117 S. Ct. 2199, 138 L. Ed. 2d 724, Fed. Sec. L. Rep. (CCH) P 99482, 191 A.L.R. Fed. 747 (1997).

²⁸The SEC's frustration with the classical approach's limitations can be seen with how quickly post-*Chiarella* the SEC promulgated Rule 14e-3, which, in the tender offer context, completely negated *Chiarella's* fiduciary duty requirement for an insider trading violation. See, e.g., *United States v. Chest-*

man, 947 F.2d 551, 557 (1991) (en banc) (emphasis added), *cert. denied*, 503 U.S. 1004 (1992) (“One violates Rule 14e-3(a) if he trades on the basis of material nonpublic information concerning a pending tender offer that he knows or has reason to know has been acquired ‘directly or indirectly’ from an insider of the offeror or issuer, or someone working on their behalf. Rule 14e-3(a) is a disclosure provision. It creates a duty in those traders who fall within its ambit to abstain or disclose, *without regard to whether the trader owes a pre-existing fiduciary duty to respect the confidentiality of the information.*”).

²⁹*Chiarella v. U. S.*, 445 U.S. 222, 235–236, 100 S. Ct. 1108, 63 L. Ed. 2d 348, Fed. Sec. L. Rep. (CCH) P 97309 (1980).

³⁰*U.S. v. O’Hagan*, 521 U.S. 642, 652, 117 S. Ct. 2199, 138 L. Ed. 2d 724, Fed. Sec. L. Rep. (CCH) P 99482, 191 A.L.R. Fed. 747 (1997).

³¹*Id.*

³²*Id.*

³³*Id.* at 655.

³⁴ Mehta, Reeb & Wanli Zhao, *Shadow Trading*, 96 ACCT. REV. 367, 368 (2021).

³⁵Sec. & Exch. Comm’n v. Panuwat, Case No. 3:21-cv-06322-WHO (N.D. Cal. Aug. 17, 2021) (ECF. 1 at 9–10) [hereinafter the “Panuwat Complaint”].

³⁶*Id.* at 5.

³⁷*Id.*

³⁸*Id.* at 7.

³⁹*Id.* at 8.

⁴⁰*Id.*

⁴¹*Id.* at 9.

⁴²*Id.* (ECF. 155 at 17) [hereinafter the “Panuwat Final Jury Instructions”].

⁴³*Securities and Exchange Commission v. Panuwat*, 702 F. Supp. 3d 883, 123 Fed. R. Evid. Serv. 3028, 2023 WL 9375861, *10 (N.D. Cal. 2023).

⁴⁴*Id.* at *11.

⁴⁵*Id.* at *11–12.

⁴⁶*Id.*

⁴⁷*Id.* at *15.

⁴⁸“Panuwat Final Jury Instructions, at 17.

⁴⁹*Id.* at 18.

⁵⁰Sec. & Exch. Comm’n v. Panuwat, Case No. 3:21-cv-06322-WHO (N.D. Cal. Aug. 17, 2021) (ECF. 168 at 1, 169 at 2) (Minute entry for April 5, 2024 and Verdict Form).

⁵¹Panuwat Complaint, at 5–10.

⁵²*O’Hagan*, 521 U.S. at 658. Should likely be “ensure.”

⁵³See *Chiarella v. U. S.*, 445 U.S. 222, 233, 100 S. Ct. 1108, 63 L. Ed. 2d 348, Fed. Sec. L. Rep. (CCH) P 97309 (1980).

⁵⁴*Id.*

⁵⁵This article’s reasoning touches only on establishing a duty of trust and confidence through Panuwat confidentiality agreement.

⁵⁶17 C.F.R. § 240.10b5-2.

⁵⁷§ 240.10b5-2(b)(1).

⁵⁸*United States v. Chow*, 993 F.3d 125, 139, Fed. Sec. L. Rep. (CCH) P 101082 (2d Cir. 2021).

⁵⁹It's also important to note that the defendant in *Chow*, unlike in *Panuwat*, had traded in the securities of the source of the material nonpublic information, which is why the court deemed him more like a “temporary insider” to the source corporation. *See Id.* at 138 (“We have characterized individuals who enter into such confidentiality agreements, pursuant to which they are given access to company information that they agree not to disclose, as ‘temporary insiders.’ ”

⁶⁰SEC Release Nos. 33-7881, 34-43154, IC-24599.

⁶¹Selective Disclosure and Insider Trading, 65 FR 51715, 51729 (emphasis added).

⁶²*Id.* at 41730.

⁶³Some courts have, however, disagreed that Rule 10b5-2's scope is so limited. *See, e.g., U.S. S.E.C. v. Nothern*, 598 F. Supp. 2d 167, 174–75, Fed. Sec. L. Rep. (CCH) P 95075 (D. Mass. 2009). But this disagreement is not a full-throated one, as even the *Nothern* court conceded that it was “not entirely clear whether the SEC may rely on Rule 10b5-2(b) to prove that Davis had a relationship upon which *Nothern's* misappropriation liability may be premised.” *Id.* at 175.

⁶⁴*U.S. v. O'Hagan*, 521 U.S. 642, 652, 117 S. Ct. 2199, 138 L. Ed. 2d 724, Fed. Sec. L. Rep. (CCH) P 99482, 191 A.L.R. Fed. 747 (1997) (emphasis added).

⁶⁵§ 240.10b5-2.

⁶⁶*E.g., Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 214, 96 S. Ct. 1375, 47 L. Ed. 2d 668, Fed. Sec. L. Rep. (CCH) P 95479 (1976) (the scope of the SEC's rulemaking cannot exceed the power Congress has granted under § 10(b)).

⁶⁷*See, e.g., United States v. Kosinski*, 2017 WL 3527694, *5 (D. Conn. 2017) (citing *Chevron, U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837, 843, 104 S. Ct. 2778, 81 L. Ed. 2d 694, 21 Env't. Rep. Cas. (BNA) 1049, 14 Env'tl. L. Rep. 20507 (1984) (overruled by, *Loper Bright Enterprises v. Raimondo*, 144 S. Ct. 2244, 219 L. Ed. 2d 832, Fed. Sec. L. Rep. (CCH) P 101887 (2024)) to uphold the SEC's use of Rule 10b5-2).

⁶⁸*National Cable & Telecommunications Ass'n v. Brand X Internet Services*, 545 U.S. 967, 986, 125 S. Ct. 2688, 162 L. Ed. 2d 820, 32 A.L.R. Fed. 2d 651 (2005) (discussing *Chevron*, 467 U.S. at 843) (internal quotations removed).

⁶⁹*See Kosinski*, 2017 WL 3527694, at *5 (“The Court finds the SEC's interpretation of Section 10(b) in Rule 10b5-2 a ‘reasonable policy choice.’ ”).

⁷⁰*Loper Bright Enterprises v. Raimondo*, 144 S. Ct. 2244, 219 L. Ed. 2d 832, Fed. Sec. L. Rep. (CCH) P 101887 (2024).

⁷¹*Id.* at *22.

⁷²*Wellogix, Inc. v. Accenture, LLP*, 788 F. Supp. 2d 523, 546 (S.D. Tex. 2011).

⁷³*Willis v. Donnelly*, 199 S.W.3d 262, 277 (Tex. 2006) (Willett, J.) (quoting *Schlumberger Technology Corp. v. Swanson*, 959 S.W.2d 171, 177 (Tex. 1997)).

⁷⁴*In re McMaken*, 2018 WL 4471017, *2 (Bankr. E.D. Va. 2018) (citing *Swimwear Solution, Inc. v. Orlando Bathing Suit, LLC*, 309 F. Supp. 3d 1022, 1032–33 (D. Kan. 2018) (“The MNDA [Mutual Non-Disclosure Agreement]

expressly states that the parties shall not ‘disclose any Confidential Information of the other party to third parties or to such party’s employees,’ and that the parties agree to ‘use [their] best efforts to protect the secrecy of and avoid disclosure and unauthorized use of the Confidential Information of the other party.’ Therefore, any alleged breach of these duties cannot constitute an independent tort under Kansas law.”); *Speedfit LLC v. Woodway USA, Inc.*, 53 F. Supp. 3d 561, 582, 89 Fed. R. Serv. 3d 1898 (E.D. N.Y. 2014) (“Plaintiffs do not allege, however, that the parties had a relationship of higher trust independent of their obligations under the two nondisclosure agreements upon which plaintiffs rely. Thus, the breach of fiduciary duty claim must be dismissed.”); *Oculus Optikgerate GmbH v. Insight Instruments, Inc.*, 2013 WL 12095533, *4 (S.D. Fla. 2013) (dismissing breach of fiduciary duty claim grounded in nondisclosure agreement); *Wellogix*, 788 F.Supp.2d at 546 (“The agreements here do not automatically create fiduciary duties simply because they were confidentiality agreements.”); *Goodworth Holdings Inc. v. Suh*, 239 F. Supp. 2d 947, 960 (N.D. Cal. 2002), *aff’d*, 99 Fed. Appx. 806 (9th Cir. 2004) (internal citations omitted) (“A confidentiality agreement does not give rise to a fiduciary relationship unless it does so expressly.”)).

⁷⁵*S.E.C. v. Cuban*, 634 F. Supp. 2d 713, 717, Fed. Sec. L. Rep. (CCH) P 95310 (N.D. Tex. 2009), judgment entered, (Aug. 13, 2009) and vacated and remanded, 620 F.3d 551, Fed. Sec. L. Rep. (CCH) P 95864 (5th Cir. 2010).

⁷⁶*Id.*

⁷⁷*Id.* at 718.

⁷⁸*Id.*

⁷⁹*Id.* at 721.

⁸⁰*Id.* at 728.

⁸¹*Id.* at 725.

⁸²A jury subsequently found Mr. Cuban not guilty of insider trading. For an excellent overview of the case and key filings, *See* Marc I. Steinberg, *The Securities and Exchange Commission v. Cuban—A Trial of Insider Trading* (Twelve Tables Press 2019).

⁸³*Securities and Exchange Commission v. Panuwat*, 702 F. Supp. 3d 883, 123 Fed. R. Evid. Serv. 3028, 2023 WL 9375861, *10 (N.D. Cal. 2023).

⁸⁴*Id.* (ECF. 81 at 6) [hereinafter “Investors Choice Amicus Brief”].

⁸⁵*Id.*

⁸⁶Sec. & Exch. Comm’n v. Panuwat, Case No. 3:21-cv-06322-WHO (N.D. Cal. Aug. 17, 2021) (ECF. 168 at 1, 169 at 2) (Minute entry for April 5, 2024 and Verdict Form).

⁸⁷Investors Choice Amicus Brief, at 7.

⁸⁸*Id.*

⁸⁹*U.S. v. O’Hagan*, 521 U.S. 642, 689, 117 S. Ct. 2199, 138 L. Ed. 2d 724, Fed. Sec. L. Rep. (CCH) P 99482, 191 A.L.R. Fed. 747 (1997) (Thomas, J., concurring in part).

⁹⁰*Id.* at 690.

⁹¹Tiger Global Management LLC (2024, Mar. 31). Form 13F. Retrieved from <http://www.sec.gov/edgar.shtml> (showing \$874,966,844 worth of Nvidia shares).

⁹²If Tiger Global Management invested in a startup with better technology than Nvidia in the computer hardware manufacturing space, that information

would certainly inform Tiger's decision to carry (or not) such a large number of Nvidia shares.

⁹³*Alaska Airlines, Boeing stock prices drop following 737 Max 9 door plug blowout*, MSN (Jan. 8, 2024), <https://www.msn.com/en-us/money/markets/alaska-airlines-boeing-stock-prices-drop-following-737-max-9-door-plug-blowout/ar-A1mEMSI#:text=Alaska%20Airlines%2C%20Boeing%20and%20Spirit%20Aero%20systems%20stock%20prices,from%20Portland%20was%20torn%20from%20the%20plane%20midair> (last accessed July 13, 2024).

⁹⁴*U.S. v. O'Hagan*, 521 U.S. 642, 645, 117 S. Ct. 2199, 138 L. Ed. 2d 724, Fed. Sec. L. Rep. (CCH) P 99482, 191 A.L.R. Fed. 747 (1997) (emphasis added).

⁹⁵The *Panuwat* case has not yet been appeal as Panuwat's Rule 50(b) motion is still outstanding as of July 13, 2024. But once appealed, the Ninth Circuit will likely need to address whether shadow insider theory is even a permissible use of SEC authority.

⁹⁶*Id.* at 655.

⁹⁷*Id.* at 658.