

SEC Cultivates Shadow Trading Theory: Emerging Species of 10b-5 Violation?

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Due to the lack of a detailed governing statute or rule, insider trading law continues to evolve and grow as novel theories are presented to and interpreted by the federal courts. Recently, a new theory emerged: shadow trading liability, i.e., using confidential knowledge about an insider's company to trade profitably in a competitor company's securities. Unlike the traditional insider trading case, shadow trading involves securities that are not related to the insider's company or any direct counterparty or merger partner.

SEC v. Panuwat is the first case to address this novel theory of potential liability. There, the Securities and Exchange Commission alleged that, in violation of Section 10(b) of the 1934 Securities Exchange Act and Rule 10b-5 thereunder, Panuwat — a former investment banker and executive at a midsize biopharmaceutical company — used confidential information about the company's pending merger to buy stock options in another company in the same industry.

In January of this year, a federal district court in the Ninth Circuit denied Panuwat's motion to dismiss and allowed the complaint to proceed on this matter of "first impression." The court opined that confidential information about the pending merger of an insider's company could be material to a company similarly situated, that is, in the same industry but not directly connected. The court found that this theory of liability, though unique, fell "within the contours of the misappropriation theory" under Section 10(b) and Rule 10b-5 and did not offend Panuwat's due process rights because the scienter and materiality elements "provide[d] sufficient guardrails to insider trading liability."

The court noted that Section 10(b) and Rule 10b-5 "cast a wide net, prohibiting insider trading of 'any security' using 'any manipulative or deceptive device.'" The court also found that information may be material to more than one company and that the SEC had sufficiently alleged scienter under either the "actual use" standard (i.e., Panuwat used the information in trading) or the "awareness" standard

(i.e., Panuwat was simply aware of the information when trading), noting that district courts within the Ninth Circuit were in disagreement as to which of those standards is applicable.

Here, on a motion to dismiss, the federal district court was required to assume the complaint's allegations as true. Next, this case will proceed to discovery and, perhaps, to trial, wherein the SEC's novel theory of insider trading would again be tested.

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