

THE SOLUTION TO SHADOW TRADING IS NOT FOUND IN CURRENT INSIDER TRADING LAW: A PROPOSED AMENDMENT TO RULE 10B5-2

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ABSTRACT

Shadow trading is a lucrative way to exploit a loophole in insider trading law. Insiders abuse this loophole to make six-figure profits and escape liability when done at the right companies. Those who shadow trade use material, nonpublic information to trade not in the securities of their own company, which would be illegal, but in the securities of a closely related company where the information is just as impactful. Efforts to close this loophole rely on the individual insider trading policies of the involved companies. These policies vary in language, making liability for shadow trading dependent on specific language or “magic words” within any given company’s policy. This leaves half of insiders free to shadow trade while the rest will be liable for insider trading. A clear rule prohibiting shadow trading is needed to adequately protect investors and the market as a whole.

Insider trading is regulated to protect investors from ending up on the wrong side of an unfair trade due to insiders possessing material, nonpublic information. This regulation, in turn, promotes confidence in the market, keeping investors from refusing to participate in what would be a rigged game without it. Amending Rule 10b5-2 to create an additional circumstance where a duty of trust and confidence exists when possessing material, nonpublic information affecting a closely related company is necessary to uphold the protection of investors and market integrity which is the basis of insider trading law.

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INTRODUCTION

In an everlasting endeavor to profit from buying and selling securities, traders find loopholes in the laws designed to limit their ability to take advantage of other investors and simultaneously harm the securities market. In response, the laws prohibiting insider trading have continually evolved to capture new instances of insider trading.¹ Yet, once again, the law finds itself one step behind. In an attempt to catch up, the government has filed charges against Matthew Panuwat, a senior director at Medivation, an oncology-focused biopharmaceutical company.² Upon learning that Pfizer was resolving the final details to acquire Medivation, Panuwat purchased call options in Incyte, a comparable oncology-focused biopharmaceutical company.³ After the announcement of the acquisition, Incyte's stock rose to a high of \$84.39, up from its previous closing at \$76.11 and Panuwat earned \$107,066 on his trade.⁴

Opportunities for insiders to profit using material, nonpublic information about one company to trade in another company's securities arise in various contexts, particularly mergers and acquisitions. In what could be the biggest acquisition announcement of 2022 at \$68.7 billion, on January 18, 2022, Microsoft announced it would acquire Activision Blizzard.⁵ As a result, the stock of Electronic Arts, one of Activision's biggest competitors, rose significantly, reaching a high of \$142.55, up from its previous closing at \$130.44.⁶

While current insider trading law prohibits Panuwat from purchasing securities in Medivation, and similarly prohibits insiders at Activision from purchasing securities in their own company, traders have exploited

1. See generally *SEC v. Tex. Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968); *Chiarella v. United States*, 445 U.S. 222 (1980); *United States v. O'Hagan*, 521 U.S. 642 (1997).

2. See generally Complaint, *SEC v. Panuwat*, No. 21-CV-06322 (N.D. Cal. Aug. 17, 2021).

3. *Id.* at *2.

4. *Id.*

5. Kison Patel, *11 Biggest M&A Deals of 2022 (So Far)*, DEALROOM, <https://dealroom.net/blog/biggest-m-a-deals-2022> [<https://perma.cc/XYK3-LYAU>] (last updated Dec. 29, 2022). At the time of this Note the acquisition is set to be completed in June of 2023 with the Federal Trade Commission posing a possible threat to the deal. See Casey O'Connor, *Will Tech's Biggest Merger Succeed?*, FORDHAM J. CORP. & FIN. L. BLOG (Mar. 2, 2023), <https://news.law.fordham.edu/jcfl/2023/03/02/will-techs-biggest-merger-succeed/>.

6. *Electronic Arts Inc. Common Stock*, NASDAQ, <https://www.nasdaq.com/market-activity/stocks/ea/historical> [<https://archive.ph/8D2II>] (last visited Mar. 2, 2023).

a loophole in the law by using material, nonpublic information about one company to purchase securities in another closely related company—that is, by shadow trading. It is estimated that the average profit of a shadow trade is between \$139,400 to \$678,000.⁷ Shadow trading exposes a loophole in insider trading law, as the current law does not cover trading in a separate but closely related company’s securities.⁸ Both “classical” and “misappropriation” theories only cover trading in the securities of the company from which the information is derived or of a company directly involved in the deal.⁹ The classical theory established a duty to disclose or abstain from trading for insiders with a fiduciary duty to their company’s shareholders.¹⁰ The misappropriation theory established a duty for outsiders who have no fiduciary relationship with stockholders but were entrusted with material, nonpublic information by involved companies.¹¹ Rule 10b5-2 added additional circumstances where a duty of trust and confidence could exist, creating more potential liability for insider trading, but still failed to address trading in a separate but closely related company’s securities.¹² Typically, when the Securities and Exchange Commission (SEC) finds a loophole in insider trading jurisprudence, they close it by adopting a new rule or an amendment to an existing rule.¹³

This Note addresses shadow trading by describing its relationship to insider trading and identifying the loophole in the prohibition of insider trading that permits it in many circumstances. Part I gives an overview of securities laws relevant to insider trading by examining the evolution of the Securities Exchange Act, Rule 10b-5, and the common law regulating insider trading. It then articulates the parameters of shadow trading. Finally, it examines the justifications for prohibiting insider trading.

7. Mihir N. Mehta, David M. Reeb & Wanli Zhao, *Shadow Trading*, 96 ACCT. REV. 367, 368 (2021).

8. SEC v. Panuwat, No. 21-CV-06322, 2022 WL 633306, at *8 (N.D. Cal. Jan. 14, 2022).

9. See generally Chiarella v. United States, 445 U.S. 222 (1980); United States v. O’Hagan, 521 U.S. 642 (1997).

10. Chiarella, 445 U.S. at 227.

11. O’Hagan, 521 U.S. at 652-53.

12. See 17 C.F.R. § 240.10b5-2 (2022).

13. See Roberta S. Karmel, *Regulation by Exemption: The Changing Definition of an Accredited Investor*, 39 RUTGERS L.J. 681, 701 (2008); see also 17 C.F.R. § 240.10b5-2 (2022). 10b5-2 is an amendment to Rule 10b-5 creating additional circumstances from which arise a duty of trust and confidence. *Id.*

Part II demonstrates the loophole in current insider trading law that permits shadow trading by exploring three hypothetical situations in which trading in the securities of another closely related company would be permitted, even though trading in the securities of the company that is the source of the information would be prohibited.

Finally, this Note summarizes the need for a rule to prohibit shadow trading and proposes an amendment to Rule 10b5-2. Part III examines the relationship between the reasons for prohibiting insider trading and shadow trading and proposes an amendment to Rule 10b5-2 that would prohibit shadow trading. Part III applies the amended Rule 10b5-2 to the hypotheticals that use the loophole to evade current insider trading law.

I. DEVELOPMENT OF INSIDER TRADING LAW

“Far from a succinctly-stated law neatly tied to a statute, insider trading is a common law edifice, hand-built over the past five decades through myriad judicial decisions, each presenting highly fact-intensive disputes.”¹⁴ As far back as 1909, the Supreme Court ruled that an insider’s failure to disclose the impending sale of land in connection with the purchase of stock amounted to fraud or deceit.¹⁵ It would not be for another 25 years that the Securities Exchange Act would establish the SEC,¹⁶ and introduce Section 10(b) as a “catch-all” for securities related fraudulent practices.¹⁷ This Part provides a brief history of insider trading, why it is regulated, and the development of laws surrounding it, including Rule 10b-5 and common law.

A. RULE 10B-5

Section 10(b) of the Securities Exchange Act reads in part:

It shall be unlawful for any person, directly or indirectly, . . . [t]o use or employ, in connection with the purchase or sale of any security. . . . [A]ny manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may

14. Tai H. Park, Newman/Martoma: *The Insider Trading Law’s Impasse and the Promise of Congressional Action*, 25 *FORDHAM J. CORP. & FIN. L.* 1, 7 (2020).

15. *Strong v. Repide*, 213 U.S. 419, 421 (1909).

16. 15 U.S.C. § 78d (2018).

17. *United States v. Newman*, 773 F.3d 438, 445 (2d Cir. 2014), *abrogated by* *Salman v. United States*, 580 U.S. 39 (2016).

prescribe as necessary or appropriate in the public interest or for the protection of investors.¹⁸

Rule 10b-5 adds that it shall be unlawful to employ any scheme, untrue statement, omission, or engage in acts that constitute fraud or deceit in connection with the purchase or sale of securities.¹⁹

In 1966 the SEC brought suit against multiple insiders of Texas Gulf Sulphur (“TGS”) in violation of Section 10(b) and Rule 10b-5.²⁰ In *Texas Gulf*, the SEC alleged that several TGS insiders engaged in the purchase of TGS securities on the basis of material, nonpublic information.²¹ Several members of TGS conducted an aerial geological survey of eastern Canada, revealing anomalies in the conduction of electricity within the rocks in the area.²² TGS then drilled a hole in one of the areas where this anomaly existed near Timmins, Ontario, later identified as “Kidd 55.”²³ The results of drilling on Kidd 55 revealed the presence of valuable minerals.²⁴ While in possession of the positive results of drilling, several members of TGS purchased stock or call options of TGS securities.²⁵ After the official announcement was made to the public, the stock of TGS rose significantly.²⁶

On appeal, the court found that the press release was issued in a manner that affected both TGS stock and the investing public.²⁷ Those in possession of the drilling results were in a position where they alone could evaluate the potential of a major ore strike and invest without risk based on those results.²⁸ The Second Circuit found that the congressional purpose of Rule 10b-5 was to give all investors in the market equal access and therefore subject all investors to identical risk.²⁹ Therefore, those possessing material, nonpublic information must disclose it to the

18. 15 U.S.C. § 78j (2018).

19. 17 C.F.R. § 240.10b-5 (2022).

20. *See generally* SEC v. Tex. Gulf Sulphur Co., 258 F. Supp. 262 (S.D.N.Y. 1966), *aff’d in part, rev’d in part*, 401 F.2d 833 (2d Cir. 1968).

21. SEC v. Tex. Gulf Sulphur Co., 401 F.2d 833, 839 (2d Cir. 1968).

22. *Tex. Gulf Sulphur Co.*, 258 F. Supp. at 269-70.

23. *Id.* at 270.

24. *Id.* at 271.

25. *Tex. Gulf Sulphur Co.*, 401 F.2d at 847.

26. *Id.*

27. *Id.* at 864.

28. *Id.*

29. *Id.* at 851-52.

investing public or abstain from trading.³⁰ Because the insiders who purchased TGS failed to disclose or abstain, “all transactions in TGS stock or calls by individuals apprised of the drilling results of K-55-1 were made in violation of Rule 10b-5.”³¹ This was the birth of the “equal access theory.”³²

B. CLASSICAL THEORY

The equal access theory did not last long. Fifteen years later, the Supreme Court was tasked once again with how to interpret and implement Section 10(b) and Rule 10b-5.³³ Chiarella, a printer or “mark up man” at a financial printer, was indicted on 17 counts of violating Section 10(b) and Rule 10b-5 after he made more than \$30,000 by figuring out the names of corporations targeted in corporate takeovers from documents sent to the printer.³⁴ Chiarella did not work at any of the target companies involved, but the information came directly from the acquiring companies.³⁵ The SEC alleged Chiarella violated Section 10(b) and Rule 10b-5 by failing to disclose the insider information he possessed before purchasing stock in the target companies, thereby breaching his duty to disclose.³⁶ In making those allegations, the SEC emphasized that such duty arises from “(i) the existence of a relationship affording access to inside information intended to be available only for a corporate purpose, and (ii) the unfairness of allowing a corporate insider to take advantage of that information by trading without disclosure.”³⁷

The Court disagreed, noting that “not every instance of financial unfairness constitutes fraudulent activity under § 10(b).”³⁸ While Chiarella did remain silent about his knowledge when trading, for silence to violate Section 10(b) one must owe a duty of disclosure.³⁹ He was not a corporate insider, did not owe a fiduciary duty, and no duty could arise

30. *Id.* at 848.

31. *Id.* at 852.

32. See Nicholas Gervasi, Note, *Blacking Out Congressional Insider Trading: Overlaying a Corporate Mechanism upon Members of Congress and Their Staff to Curtail Illegal Profiting*, 28 FORDHAM J. CORP. & FIN. L. 223, 234 (2023).

33. See *Chiarella v. United States*, 445 U.S. 222, 225 (1980).

34. *Id.* at 224-25.

35. See *id.* at 224.

36. *Id.* at 222.

37. *Id.* at 227.

38. *Id.* at 232.

39. *Id.*

from his relationship with the sellers as he was a “complete stranger who dealt with the sellers only through impersonal market transactions.”⁴⁰ The Court, in overruling the Second Circuit, reasoned that finding Chiarella in violation of Section 10(b) would impose a duty to abstain or disclose on all participants in market transactions.⁴¹ And that “[f]ormulation of such a broad duty, which departs radically from the established doctrine that duty arises from a specific relationship between two parties, should not be undertaken absent some explicit evidence of congressional intent.”⁴² In addition to the Court finding Chiarella’s actions were not in violation of Section 10(b), the case dismantled the “equal access theory” and established the “classical theory.”

C. MISAPPROPRIATION THEORY

1. O’Hagan

As the use of material, nonpublic information expanded, so did the theories of insider trading. After the Court in *Chiarella* “expressly left open the misappropriation theory,”⁴³ the Supreme Court would recognize this theory years later. In July 1988, Grand Metropolitan PLC (“Grand Met”) retained the law firm Dorsey & Whitney to assist with a tender offer for Pillsbury Company common stock.⁴⁴ James O’Hagan was a partner at Dorsey & Whitney during the representation of Grand Met, but O’Hagan did not participate in the representation personally.⁴⁵ By the end of September, O’Hagan purchased 2,500 Pillsbury call options and 5,000 shares of Pillsbury common stock.⁴⁶ Grand Met announced its tender offer for Pillsbury stock in October, and O’Hagan sold his call options and shares, profiting upwards of 4.3 million dollars.⁴⁷ In response, O’Hagan was charged with 17 counts of securities fraud in violation of Section 10(b) and Rule 10b-5.⁴⁸

40. *Id.*

41. *Id.* at 233

42. *Id.*

43. *United States v. O’Hagan*, 521 U.S. 642, 662 (1997).

44. *Id.* at 647.

45. *Id.*

46. *Id.* at 647-48.

47. *Id.*

48. *Id.* at 649-50.

This presented a unique circumstance, as O'Hagan did not work for either of the corporations involved in the tender offer. On these facts, the Court recognized the "misappropriation theory."⁴⁹ Under *Chiarella*, O'Hagan would have been prohibited from trading securities of the acquiring company due to his duty of trust and confidence to them, but under the misappropriation theory, O'Hagan was prohibited from trading securities of both the acquiring and target companies.⁵⁰ The difference in theories that allowed for the prosecution of O'Hagan relies on the concept that there is a duty owed to the source of the information.⁵¹ The Court explained this difference by stating, "[i]n lieu of premising liability on a fiduciary relationship between company insider and purchaser or seller of the company's stock, the misappropriation theory premises liability on a fiduciary-turned-trader's deception of those who entrusted him with access to confidential information."⁵²

2. Rule 10b5-2

In response to the *Chestman* decision, which failed to protect investors from the misappropriation and the misuse of insider information, the SEC promulgated Rule 10b5-2.⁵³ In 1991 the Second Circuit reversed a conviction of ten counts of securities fraud in violation of Section 10b and Rule 10b-5 against Robert Chestman.⁵⁴ Chestman, a stockbroker, found himself at the end of a long chain of relayed insider information.⁵⁵ Ira Waldbaum, the owner of Waldbaum, a publicly traded company and supermarket chain, decided to sell the chain in 1986.⁵⁶ After making the decision, Waldbum told his sister Shirley Witkin about the imminent sale.⁵⁷ He included that the sale was "not to be discussed" when

49. See *id.* at 652.

50. See Kayla Quigley, *The Insider Trading Prohibition Act: A Small Step Towards a Codified Insider Trading Law*, 26 FORDHAM J. CORP. & FIN. L. 183, 189 (2021).

51. See *O'Hagan*, 521 U.S. at 652.

52. *Id.*

53. Donna M. Nagy, *Insider Trading and the Gradual Demise of Fiduciary Principles*, 94 IOWA L. REV. 1315, 1359 (2009).

54. *United States v. Chestman*, 947 F.2d 551, 554 (2d Cir. 1991).

55. *Id.* at 555.

56. *Id.*

57. *Id.*

sharing the news.⁵⁸ Shirley then told her daughter Susan Loeb, who then told her husband, Keith Loeb.⁵⁹

After hearing the news about the upcoming sale, Mr. Loeb called his stockbroker Chestman.⁶⁰ After speaking to Mr. Loeb the following morning, Chestman purchased 3,000 shares of Waldbaum stock for himself and 8,000 shares for his clients, including Mr. Loeb.⁶¹ The alleged misappropriator here is Mr. Loeb, as he is accused of having breached a fiduciary duty to his wife when he told Chestman of the sale, making him a tipper and Chestman a tippee in the insider trading of Waldbaum stock.⁶²

The court found that while Keith was married to Susan and told not to share the information, the marriage itself did not create a fiduciary duty.⁶³ Since Keith did not owe his wife or the Waldbaums a fiduciary duty, neither he nor Chestman could be found guilty of violating Section 10b or Rule 10b-5.⁶⁴ While the *Chestman* decision focused on familial and personal relationships, the SEC took this opportunity to expand on what should create a duty of trust.⁶⁵ Rule 10b5-2 now establishes that a duty of trust or confidence exists in a non-exclusive list of circumstances.⁶⁶ It reads:

- (1) Whenever a person agrees to maintain information in confidence;
- (2) Whenever the person communicating the material nonpublic information and the person to whom it is communicated have a history, pattern, or practice of sharing confidences, such that the recipient of the information knows or reasonably should know that the person communicating the material nonpublic information expects that the recipient will maintain its confidentiality; or
- (3) Whenever a person receives or obtains material nonpublic information from his or her spouse, parent, child, or sibling; provided, however, that the person receiving or obtaining the information may

58. *Id.*

59. *Id.*

60. *Id.*

61. *Id.*

62. *Id.* at 570.

63. *Id.* at 571.

64. *Id.*

65. Ryan M. Davis, *Trimming the "Judicial Oak": Rule 10b5-2(b)(1), Confidentiality Agreements, and the Proper Scope of Insider Trading Liability*, 63 VAND. L. REV. 1469, 1485 (2010).

66. 17 C.F.R. § 240.10b5-2 (2022).

demonstrate that no duty of trust or confidence existed with respect to the information, by establishing that he or she neither knew nor reasonably should have known that the person who was the source of the information expected that the person would keep the information confidential, because of the parties' history, pattern, or practice of sharing and maintaining confidences, and because there was no agreement or understanding to maintain the confidentiality of the information.⁶⁷

3. *Shadow Trading*

In *Panuwat*, the SEC complaint alleged that Panuwat violated Section 10(b) and Rule 10b-5 under the misappropriation theory when he used material, nonpublic information of an imminent acquisition to trade short-term stock options in a similar company in the oncology biopharmaceutical market.⁶⁸ Panuwat was a senior director of business development during his time at Medivation.⁶⁹ While in that position, Panuwat received an email from the CEO of Medivation informing him that an acquisition of Medivation by Pfizer was imminent pending final details.⁷⁰ The SEC alleged that Panuwat was informed through his work with investment bankers that Incyte, another biopharmaceutical company, was similar to Medivation.⁷¹ Having never traded Incyte stock before, Panuwat purchased 578 Incyte call options⁷² at prices of \$80, \$82.50, and \$85 per share within minutes of receiving the email of the looming acquisition.⁷³ Several days after purchasing the options, Medivation publicly announced that Pfizer would acquire them.⁷⁴ As a result of the announcement, and the similarity of Medivation and Incyte, the following Monday, Incyte's stock reached a high of \$84.39 and closed around eight percent higher than its closing price the previous Friday.⁷⁵ The spike in

67. *Id.*

68. SEC v. Panuwat, No. 21-CV-06322, 2022 WL 633306, at *5 (N.D. Cal. Jan. 14, 2022).

69. *Id.* at *1.

70. *Id.* at *2.

71. *Id.* at *1.

72. "A call option is a financial contract that, for a fee, gives you the right but not the obligation to purchase a specific stock at a set price on or before a predetermined date." Jim Probasco, *What Is a Call Option?*, BUS. INSIDER (last updated Sept. 21, 2022, 11:08 AM), <https://www.businessinsider.com/personal-finance/call-option> [<https://perma.cc/CGN3-DWUA>].

73. Complaint at 8, SEC v. Panuwat, No. 21-CV-06322 (N.D. Cal. Aug. 17, 2021).

74. *Id.* at 8-9.

75. *Id.* at 9.

Incyte's stock price earned Panuwat \$107,066 in profit on the options he purchased.⁷⁶ This loophole that allows insiders to trade in closely related companies based on material, nonpublic information gathered from their own company is referred to as shadow trading.⁷⁷

D. THE PURPOSE OF REGULATING INSIDER TRADING

The most compelling reasons behind the regulation of insider trading are the protection of investors and confidence in the market.⁷⁸ “[T]he phrase ‘protection of investors’ appears in what is arguably the single most important section of federal securities law.”⁷⁹ While there is little evidence of Congress’s intent behind the Exchange Act, protecting investors is “indisputably” one of the goals.⁸⁰ The SEC also stated in its proposal of Rule 10b5-2 that its goal is to “protect investors and the fairness and integrity of the nation’s securities markets against improper trading on the basis of inside information.”⁸¹

Insider trading is sometimes described as a victimless crime.⁸² However, while victims are often anonymous, insider trading does have victims.⁸³ When an insider trade happens, the insider makes a gain or avoids a loss when the information or reason they traded becomes public.⁸⁴ As a consequence, the anonymous trader on the other end

76. *Panuwat*, 2022 WL 633306, at *1.

77. See Mehta et al., *supra* note 7, at 1 (“The premise of shadow trading is straightforward: private information held by insiders can also be relevant for economically-linked firms and exploited to facilitate profitable trading in those firms.”).

78. Andrew W. Marrero, *Insider Trading: Inside the Quagmire*, 17 BERKELEY BUS. L.J. 234, 297–98 (2020).

79. Michael D. Guttentag, *Protection from What? Investor Protection and the Jobs Act*, 13 U.C. DAVIS BUS. L.J. 207, 212 (2013).

80. Lacey S. Calhoun, *Moving Toward a Clearer Definition of Insider Trading: Why Adoption of the Possession Standard Protects Investors*, 32 U. MICH. J.L. REFORM 1119, 1123 (1999).

81. Selective Disclosure and Insider Trading, 64 Fed. Reg. 72590, 72590–611 (Dec. 28, 1999) (to be codified at 17 C.F.R. pts. 230, 240, 243, 249).

82. See George W. Dent, Jr., *Why Legalized Insider Trading Would Be a Disaster*, 38 DEL. J. CORP. L. 247, 259 (2013).

83. William K.S. Wang, *Stock Market Insider Trading: Victims, Violators and Remedies-Including an Analogy to Fraud in the Sale of a Used Car with a Generic Defect*, 45 VILL. L. REV. 27, 63 (2000).

84. *Id.* at 64.

inherits a loss or misses out on a gain they could not have foreseen.⁸⁵ This “informational advantage that the public is unable lawfully to overcome or offset” is what securities laws seek to preclude.⁸⁶ It follows logically that an investor who misjudges the market may try again, but an investor who finds out they were on the wrong end of an insider trade will withdraw from the market to avoid being a repeat victim.

Insider trading harms not only individual victims, but also the broader securities market.⁸⁷ Therefore, the reasoning for regulating insider trading is often rooted in the protection of the market. The Supreme Court stated that common law doctrines against insider trading were designed to protect the integrity of the securities market.⁸⁸ Without these protections, the public would be discouraged from trading in the securities market.⁸⁹ If the public still trades, the integrity of prices becomes an issue and a justification for insider trading regulations.⁹⁰ For example, one theory is that if the public thinks they are trading with someone with insider information, they will demand a premium on any trade due to a market overrun with insider trading.⁹¹ Thus, the prices of securities would not reflect their value or all available information as intended.

II. ANALYZING HOW SHADOW TRADERS ESCAPE LIABILITY UNDER CURRENT LAW

The issue this Note seeks to remedy is how shadow trading, through a loophole, evades the existing law prohibiting insider trading. Much like in *Chiarella*,⁹² the lack of a fiduciary relationship to shareholders in shadow trading frees a trader from the duty to disclose. For example, this

85. *Id.*

86. Victor Brudney, *Insiders, Outsiders, and Informational Advantages Under the Federal Securities Laws*, 93 HARV. L. REV. 322, 360 (1979).

87. See Michael A. Perino, *The Lost History of Insider Trading*, 2019 U. ILL. L. REV. 951, 953–54 (2019).

88. *United States v. O’Hagan*, 521 U.S. 642, 653 (1997).

89. See *id.* at 658.

90. See Steve Thel, *The Original Conception of Section 10(b) of the Securities Exchange Act*, 42 STAN. L. REV. 385, 392 (1990) (arguing the fundamental purpose of the Securities Exchange Act is to protect the public interest in the integrity of the prices of securities and a plain reading of Section 10(b) gives the SEC authority to regulate any practice that defeats it).

91. Alexandre Padilla, *Should the Government Regulate Insider Trading?*, 22 J. LIBERTARIAN STUD. 379, 382–83 (2011).

92. See generally *Chiarella v. United States*, 445 U.S. 222 (1980).

loophole in the law would also be present in instances where an insider purchases stock in their company's supplier before a new product announcement, knowing that the supplier's stock will increase after the announcement has been made. While the insider would owe a duty to disclose to their own company, they would not owe a duty to the supplier, and yet they are left with material, nonpublic information of extreme value far before the public would have a chance to benefit.

In *Panuwat*, a key piece of information in the SEC's allegations and pursuit of shadow trading is that Panuwat signed a company policy prohibiting him from using material, nonpublic information learned through his job to trade Medivation securities "or the securities of another publicly traded company, including all significant collaborators, customers, partners, suppliers, or competitors of the Company."⁹³ This policy established the duty to the source of the information required under the misappropriation theory.⁹⁴ Because Panuwat signed the policy, he opened the door for the SEC to argue that he owed the duty to the source of the information—Medivation—not to trade on the nonpublic imminent acquisition of Medivation. This Part addresses the current theory of shadow trading, additional factors and circumstances not considered by current case law, and the inability to prohibit shadow trading with insider trading law. Consider the following hypothetical scenarios of shadow trading.⁹⁵

A. INSTANCES OF SHADOW TRADING

1. Scenario One: Supplier

Company A is a company that produces vaccines for deadly viruses. Suppose that an executive at Company A, due to their position, receives an email from the CEO that a breakthrough has been made on a vaccine that has been deemed safe for human use and millions of doses will now be produced. This executive then takes that material, nonpublic information and purchases stock in Company B, which supplies needles

93. SEC v. *Panuwat*, No. 21-CV-06322, 2022 WL 633306, at *1 (N.D. Cal. Jan. 14, 2022).

94. *O'Hagan*, 521 U.S. at 652.

95. A "security" covers a vast amount of possibilities. Rather than using all possible instances of securities in a company, for ease of exposition, this Note uses stocks or call options when referring to securities in a company.

for Company A's vaccine. After Company A announces that the vaccine has been approved and will be administered to the public, Company B's stock rises significantly. The stock purchased by the executive at Company A in Company B is now worth hundreds of thousands of dollars more, and the executive sells the stock cashing in on the spike in price.

2. Scenario Two: Similar Acquisition Target

Company X is a small market company that conducts specialized cancer research. An executive at Company X receives an email from the CEO that Company Y will be acquiring Company X in the immediate future. The executive at Company X then takes that material, nonpublic information and purchases stock in Company Z, a close competitor of Company X, knowing that it will affect Company Z's stock price. Companies X and Y announce their acquisition, and Company Z's stock price immediately rises. The stock purchased by the executive at Company X in Company Z is now worth hundreds of thousands of dollars more, and the executive sells the stock cashing in on the spike in price.

3. Scenario Three: Bankrupt Competitor

Tech Companies One and Two have been working on a new design that will change the entire market surrounding cell phones. An executive at Tech Company One receives an email from the CEO that their company will run out of funding soon, and the newest design has failed. The executive at Tech Company One then takes that material, nonpublic information and purchases stock in Company Two, knowing that it will affect Tech Company Two's stock price. Tech Company One announces that it will be filing for bankruptcy and bowing out of the race to design a new cell phone. Tech Company Two's stock price immediately rises. The stock purchased by the executive at Tech Company One in Tech Company Two is now worth hundreds of thousands of dollars more, and the executive sells the stock cashing in on the spike in price.

B. APPLYING CLASSICAL THEORY

Banning shadow trading under the classical theory is almost impossible. In *Chiarella*, under what is now known as the classical theory, the Supreme Court held that absent a duty to disclose, there is no

fraudulent activity.⁹⁶ The duty to disclose hinges on the relationship between the corporate insider and the shareholders.⁹⁷ The unique element of shadow trading is the lack of a fiduciary duty to shareholders. In a shadow trade, the securities purchased are not that of the company for which the corporate insider works. Instead, shadow trading occurs when a corporate insider trades on material, nonpublic information by buying a competitor or closely related company's stock. Thus, the corporate insider has no duty to the shareholders of those companies—all three executives in Scenarios One, Two, and Three trade in this manner.

The executive in Scenario One uses material, nonpublic information and trades in the securities of his company's supplier. Because the executive does not have a fiduciary duty to the supplier's shareholders, the classical theory cannot apply. Similarly, the executives in Scenarios Two and Three lack a fiduciary duty to the closely related corporation's shareholders, making the classical theory inapplicable to them as well.

In this application of the law, Panuwat would also be cleared of any insider trading allegations under the classical theory. Panuwat traded stock options of a similar oncology-based biopharmaceutical company.⁹⁸ Panuwat would owe a duty to disclose if it had been the stock of Medivation, as he owes them a fiduciary duty as a corporate insider for Medivation. However, that duty did not exist with Incyte, even though Panuwat allegedly used material, nonpublic information to purchase the stock options involving Incyte.

C. APPLYING THE MISAPPROPRIATION THEORY

The misappropriation theory “premises liability on a fiduciary-turned-trader’s deception of those who entrusted him with access to confidential information.”⁹⁹ This theory captures “‘outsiders’ to a corporation who have access to confidential information that will affect th[e] corporation’s security price when revealed, but who owe no fiduciary or other duty to that corporation’s shareholders.”¹⁰⁰ The use of the language “the corporation’s securities price” as opposed to “a corporation” or “any corporation” implies that the misappropriator must

96. *Chiarella v. United States*, 445 U.S. 222, 235 (1980).

97. *Id.* at 227.

98. *Panuwat*, 2022 WL 633306, at *2.

99. *O'Hagan*, 521 U.S. at 652.

100. *Id.* at 653.

trade in the securities of one of the corporations who “entrusted” them with the material, nonpublic information.

Applying the misappropriation theory to shadow trading reveals two issues. First, under the theory of shadow trading explained in this Note, shadow traders are corporate insiders—not outsiders—to the company that entrusts them with the material, nonpublic information. For example, in *O’Hagan*, the Court ruled that O’Hagan, as an outsider, owed a duty to his law firm and client when he used material, nonpublic information of a tender offer to purchase stock in the targeted company.¹⁰¹ Shadow trading differs significantly from the trading in *O’Hagan*. A shadow trader is an insider to the company that entrusts them with the information and the material, nonpublic information is not being used to trade in the securities of the corporations from which it originated.

This leads us to the second issue. The misappropriation theory traditionally covers material, nonpublic information that is used for trading in the companies that produced the material, nonpublic information.¹⁰² The language used in the *O’Hagan* decision is clear that while no fiduciary duty is owed to shareholders, there is a duty owed to the sources—often corporations—that “entrust” a person with insider information.¹⁰³ However, if the material, nonpublic information being traded on is not in the securities of the source or the securities of a company involved in a deal with the source, the current doctrine of misappropriation does not cover such activity.

Applying the misappropriation theory to Scenarios One, Two, and Three further emphasizes the issues mentioned above. In all three scenarios, due to their positions in their own companies, the executives are entrusted with material, nonpublic information that will likely affect other companies. The argument can be made that they are outsiders to the companies in which they traded and knew that the material, nonpublic information would affect the stock of the closely related companies in which they traded. It may seem that this is exactly what *O’Hagan* was seeking to prevent.¹⁰⁴ However, O’Hagan traded on material, nonpublic information on a deal that directly involved the corporations he was an insider to and the information *they* “entrusted” him with.¹⁰⁵ The executives in each of the three scenarios—like Panuwat—stepped outside

101. *Id.* at 653-54.

102. *See generally id.*

103. *Id.* at 652.

104. *See id.* at 653.

105. *Id.* at 642.

the directly involved corporation(s) and traded in an outsider's or third party's securities. Therefore, distinct from *O'Hagan*, the executives in all three scenarios cannot be held liable under the misappropriation theory because the companies' securities in which they traded were not the companies who "entrusted" them with the material, nonpublic information.

In the case of *Panuwat*, the SEC argues that the misappropriation theory applies.¹⁰⁶ But that argument can be made because Panuwat signed a company policy agreeing not to trade Medivation securities "or the securities of another publicly traded company, including all significant collaborators, customers, partners, suppliers, or competitors of the Company."¹⁰⁷ This created a fiduciary or contractual duty not to trade on information he learned from his job.¹⁰⁸ In instances where there is no company policy in place to have employees agree not to trade on material, nonpublic information, the analysis of fiduciary duty has yet to be made. In fact, when considering whether Panuwat breached a duty to Medivation when trading in Incyte, the court did not address whether this duty existed solely based on his position at Medivation.¹⁰⁹ Instead, the court only pointed to his "contractual" duty based on the signed Medivation insider trading policy.¹¹⁰

Another argument under the misappropriation theory is that even though the executives in all three scenarios did not trade in companies directly involved, they misappropriated material, nonpublic information that belonged to their own corporations. In *Panuwat*, the court has acknowledged, and the SEC concedes, that there are no existing cases where the misappropriation theory was applied to trading on material, nonpublic information involving a third party to the information.¹¹¹ This raises the question of whether a corporate insider owes a duty to his or her own company not to trade in the securities of third-party corporations based on material, nonpublic information that was entrusted to them by their own corporation.

106. SEC v. Panuwat, No. 21-CV-06322, 2022 WL 633306, at *3 (N.D. Cal. Jan. 14, 2022).

107. *Id.* at *1.

108. *Id.* at *5.

109. *Id.* at *6.

110. *Id.*

111. *Id.* at *8.

D. APPLYING RULE 10B5-2

Rule 10b5-2 is used to define where a duty of trust and confidence to keep information private exists.¹¹² Such duty can exist under three non-exclusive circumstances:

- (1) Whenever a person agrees to maintain information in confidence;
- (2) Whenever the person communicating the material nonpublic information and the person to whom it is communicated have a history, pattern, or practice of sharing confidences, such that the recipient of the information knows or reasonably should know that the person communicating the material nonpublic information expects that the recipient will maintain its confidentiality; or (3) Whenever a person receives or obtains material nonpublic information from his or her spouse, parent, child, or sibling. . . .¹¹³

Applying Rule 10b5-2(b)(1), none of the three executives agreed to keep in confidence the material, nonpublic information they traded on. Therefore, no duty can be established under those circumstances. In *Panuwat*¹¹⁴ the key difference in establishing a duty is that Panuwat signed a company policy agreeing not to deal in the company's securities or "the securities of another publicly traded company, including all significant collaborators, customers, partners, suppliers, or competitors."¹¹⁵ Had this policy been signed by the executives in the three scenarios, they would all likely have a duty of trust and confidence under 10b5-2(b)(1) and be liable for insider trading as the court in *Panuwat* read the policy to include trading in any publicly traded company, not just the included examples.¹¹⁶ This means the determination of liability for shadow trading could turn on the existence of a company policy and how broad or narrow such policy is. For example, if a company policy did not include all publicly traded companies but only the list of "significant collaborators, customers, partners, suppliers, or competitors[.]"¹¹⁷ the SEC would need to prove that the company's securities being traded were not just those of a collaborator, partner, supplier, or competitor, but a "significant" one. Even further, the breadth of such a list in a company's policy would change liability. If a policy only included collaborators,

112. 17 C.F.R. § 240.10b5-2 (2022).

113. *Id.*

114. Which is most similar to our hypothetical Scenario Two, *supra* Section II.A.2.

115. *Panuwat*, 2022 WL 633306, at *1.

116. *Id.* at *6.

117. *Id.* at *1.

customers, partners, and competitors, but not suppliers, then the executive in Scenario One would not be liable for insider trading because they traded in the needle supplier of the company.

Applying Rule 10b5-2(b)(2), none of the three executives share a history, pattern, or practice of sharing confidences in a way that resembles how the Rule has been previously applied. Few courts have mentioned Rule 10b5-2(b)(2) directly.¹¹⁸ In *United States v. McGee*, the Third Circuit affirmed the conviction of Timothy McGee after he traded on material, nonpublic information regarding the sale of Philadelphia Consolidated Holding Corporation he received from Christopher Maguire.¹¹⁹ The court ruled that a rational fact finder could conclude that a history or pattern of sharing confidences existed between McGee and Maguire.¹²⁰ Both attended Alcoholics Anonymous meetings where McGee served as a mentor for Maguire.¹²¹ Maguire entrusted McGee with “extremely personal” confidences with the expectation that their conversations would not be disclosed.¹²² Maguire also never disclosed any of the things he learned from McGee.¹²³ This pattern went on for almost a decade, which led the court to conclude there was sufficient evidence of a history and pattern of sharing confidences under Rule 10b5-2(b)(2).¹²⁴

118. See, e.g., *United States v. McGee*, 763 F.3d 304, 318 (3d Cir. 2014) (finding a history of sharing confidences between the tipper and tippee from Alcoholics Anonymous meetings established a history or pattern of sharing confidences under Rule 10b5-2(b)(2)); *SEC v. Munakash*, No. CV 16-833-R, 2016 WL 9137640, at *1-2 (C.D. Cal. May 16, 2016) (finding the sharing of family issues, failures, financial problems, and other sensitive topics over a lengthy friendship between tipper and tippee established a history or pattern of sharing confidences under Rule 10b5-2(b)(2)); *SEC v. Conradt*, 947 F. Supp. 2d 406, 412 (S.D.N.Y. 2013) (ruling sharing of family illnesses, seeking personal legal advice, legal advice for friends, and tearful exchanges between tipper and tippee established a history or pattern of sharing confidences under Rule 10b5-2(b)(2)); *United States v. McPhail*, 831 F.3d 1 (1st Cir. 2016) (ruling tipper and tippee shared confidential information in their lengthy relationship as golf partners regarding nonpublic information on several occasions establishing a history or pattern of sharing confidences under Rule 10b5-2(b)(2)).

119. See generally *McGee*, 763 F.3d 308.

120. *Id.* at 318.

121. *Id.* at 309.

122. *Id.* at 317.

123. *Id.*

124. See *id.* at 317-18.

No such pattern or history exists in any of the three scenarios.¹²⁵ Unlike *McGee*, *McPhail*, *Conradt*, and *Munakash*, there is no history of back-and-forth confidences but only a single email in a one-sided communication. Therefore, Rule 10b5-2(b)(2) would likely fail to capture instances of shadow trading where executives learn something during the course of their job and trade in a closely related company, much like the executives in all three scenarios.

Under Rule 10b5-2(b)(3), the executives in all three scenarios could only be found to have a duty of trust or confidence if the CEO who sent them the email was a spouse, parent, child, or sibling. Because the CEO in the scenarios did not fall into those close relationships, the executives in all three scenarios had no duty of trust or confidence under Rule 10b5-2(b)(3) and cannot be held liable for insider trading.

III. AMENDING RULE 10B5-2 TO PREVENT FUTURE SHADOW TRADES

A. THE NEED FOR A RULE TO PROTECT AGAINST SHADOW TRADING

The rational behind prohibiting shadow trading is similar to that of the general regulation of securities markets. The Supreme Court, when recognizing the misappropriation theory, did so to protect the integrity of securities markets.¹²⁶ The Court reasoned that investors would not venture into a market where trading on inside information was “unchecked by law.”¹²⁷ Because current insider trading law does not capture shadow trading, it is left unchecked and gives insiders the very advantage the Court was trying to mitigate. This informational advantage also affects ordinary investors directly. The “protection of investors” emphasized in the reasons for regulating insider trading,¹²⁸ is not accomplished if shadow traders can leverage knowledge of inside information in purchasing securities. The anonymous trader on the other end of an inside trade who inherits a loss or misses out on a gain in previous theories of insider trading suffers the same consequence of being on the wrong end of shadow trades.¹²⁹

If left under the current conditions, liability of insider trading in instances of shadow trading will rest on company policies. Not only the

125. See *supra* Sections II.A.1, II.A.2, II.A.3.

126. See *United States v. O’Hagan*, 521 U.S. 642, 653 (1997).

127. See *id.* at 658.

128. Guttentag, *supra* note 80, at 212-13.

129. See Wang, *supra* note 84, at 64.

existence of a company policy but also the breadth or inclusion of some magic words that would capture the shadow trade in its prohibitions.¹³⁰ It is not only unreasonable to allow liability under the law to rest on company policies, but it also creates unfairness and inconsistency in shadow trading prosecutions. For example, if two executives both use material, nonpublic information to trade in a closely related company, but only one of their companies has a shadow trading policy, then two people committing the same act will result in only one of them being liable for insider trading. A recent study suggests only 53 percent of companies currently have a policy like Mediviation's.¹³¹ Furthermore, a policy that prohibits trading in the securities of collaborators, customers, and partners will create different liability than a policy that includes suppliers, and competitors.¹³²

The need for a new rule stems from the inability of current common law and rules to capture instances of shadow trading. The classical theory does not apply due to shadow traders' lack of a duty to disclose. Typically, company insiders have a duty to disclose stemming from the fiduciary duty between insiders and the company's shareholders.¹³³ Shadow traders do not trade in the securities of their own company, nor a company involved in a deal with their company. Instead, they trade in the securities of closely related third party companies, and therefore escape liability under classical theory because they owe no fiduciary duty to the third party's shareholders.

For misappropriation theory to apply to shadow trading, the court would need to take an extremely more aggressive approach than they have traditionally. Presently, the common law imposes liability only on traders entrusted with inside information who then trade in the securities from which the information derived.¹³⁴

The misappropriation theory rests on secretive fiduciary disloyalty.¹³⁵ "The insider deceives the source of the information—which the source entrusted to the insider with the expectation that he would act

130. See *supra* Section II.D.

131. See Mehta et al., *supra* note 7, at 29. The authors conducted a study on shadow trading involving 267 companies and their insider trading policies finding only 53 percent of companies had a policy prohibiting shadow trading. *Id.*

132. See *supra* Section II.D.

133. Chiarella v. United States, 445 U.S. 222, 227 (1980).

134. See generally United States v. O'Hagan, 521 U.S. 642 (1997).

135. Donald C. Langevoort, "Fine Distinctions" in the Contemporary Law of Insider Trading, 2013 COLUM. BUS. L. REV. 429, 441 (2013).

as a loyal fiduciary and not take personal advantage of it—by ‘feigning’ loyalty while acting selfishly.”¹³⁶ However, the idea of feigning loyalty has typically occurred when an insider knows material, nonpublic information about a company and trades in the securities of that same company or one involved in a deal.¹³⁷ No current cases cover shadow trading, which is using that information to trade in a closely related company’s securities.¹³⁸ It would be a far more aggressive approach to interpret feigning loyalty to apply to any use of material, nonpublic information. The court in *O’Hagan* stated, “misappropriators deal in deception: A fiduciary who pretends loyalty to the principal while secretly converting the principal’s information for personal gain dupes or defrauds the principal.”¹³⁹ O’Hagan “pretend[ed] loyalty” and “dupe[d] or defraud[ed]” the involved parties by purchasing stock options in the targeted company of the tender offer his firm was connected to.¹⁴⁰ O’Hagan owned more options of the target company than any other individual investor.¹⁴¹ This is disloyal because O’Hagan directly capitalized on a deal involving parties to which he owed a duty of loyalty.

The Court directly pointed out “[t]he misappropriation theory targets information of a sort that misappropriators ordinarily capitalize upon to gain no-risk profits through the purchase or sale of securities. Should a misappropriator put such information to other use, the statute’s prohibition would not be implicated.”¹⁴² It raises the question: is trading in a security that is completely separate from all companies who entrusted one with inside information still feigning loyalty? The answer to that question must be no. The trusted information that creates the need for loyalty and the selfish capitalization that breaks the loyalty do not stem from the same company. If the trading of securities that “misappropriators ordinarily capitalize upon” has always been from the directly involved companies, then anything outside of that, including trading in a separate third party, has to be considered “put[ting] such information to other

136. *Id.*

137. *See, e.g.*, Complaint at 4-7, SEC v. Glassner, No. 22-CV-04254 (S.D.N.Y. May 24, 2022) (charging biopharmaceutical consultant with insider trading when, after hearing from an executive about an imminent acquisition, he traded in the same company’s securities).

138. SEC v. Panuwat, No. 21-CV-06322, 2022 WL 633306, at *8 (N.D. Cal. Jan. 14, 2022).

139. *O’Hagan*, 521 U.S. at 643.

140. *Id.* at 647-48.

141. *Id.*

142. *Id.* at 656.

use.”¹⁴³ Therefore, a prohibition under misappropriation theory cannot apply and the loophole remains open calling for a rule outside of current misappropriation theory to address shadow trading.

B. RULE 10B5-2(B)(4) PROPOSAL

The amendment to Rule 10b5-2 that would regulate shadow trading should read:

Whenever a person receives or obtains material, nonpublic information in the course of his or her employment about his or her own company that affects, or could reasonably be expected to affect, the equity, earnings, cash flows, market value, financial condition, future prospects, or stock price of a closely related company and the person knows or reasonably should know that the person who is the source of the material, nonpublic information expects that the person will maintain its confidentiality.

SEC rules are often lengthy¹⁴⁴ but the inclusion of all the necessary language is needed for the rule to function. Here, the specific language of “affects, or could reasonably be expected to affect, the equity, earnings, cash flows, market value, financial condition, future prospects, or stock price of a closely related company” in the proposed Rule 10b5-2(b)(4) is a non-exclusive list of indicia as to what affecting a closely related company could be. This is important for narrowing the companies affected by shadow trading. Outside of common sense as to what would affect a closely related company, this list serves as a starting point for courts to consider. This allows for factors like market size, impact, relatedness, and predictability to determine liability in shadow trades.

The “knows or reasonably should know that the person who is the source of the material, nonpublic information expects that the person will maintain its confidentiality” is expected to only apply to communications that would create an expectation of confidentiality. For example, an email or other communication from the CEO stating the company is doing well would not create an expectation of confidentiality. However, any communication from the CEO not made to the public that reveals an imminent merger, acquisition, product release, earnings report, bankruptcy, etc., would create a reasonable expectation of confidentiality.

143. *See id.*

144. *See, e.g.,* 17 C.F.R. § 240.10b5-2(b)(3) (2022).

C. APPLYING 10B5-2(B)(4)

Scenario One: Supplier

The executive in Scenario One took the material, nonpublic information that the vaccine had been approved and purchased stock in the corporation's biggest needle supplier.¹⁴⁵ The executive did this anticipating that when the news was released, the needle supplier's stock price would rise. The needle supplier would have an extreme boost in production and sales of needles, given the approval of a worldwide vaccine, and the stock price would reflect this after the announcement is made. The executive also should have reasonably known that the CEO expects him to keep the approval of the vaccine confidential, as that information will affect their own company significantly and had not yet been disclosed to the public.

Since the executive traded on material, nonpublic information, he expected to affect a closely related company and was expected to keep that information in confidence he would be liable for insider trading under proposed Rule 10b5-2(b)(4). Rule 10b5-2(b)(4) specifically targets this kind of shadow trading by establishing a duty in instances where insiders possess material, nonpublic information that will affect a closely related company in a meaningful way. However, if the executive had purchased stock in a major hotel or airline, the executive would not be liable under the proposed 10b5-2(b)(4). This is because, while vaccines for deadly viruses may affect travel, a hotel or airline is not a closely related company to a vaccine producer in the same manner as a direct needle supplier would be and does not have the same chances of a minimal risk trade.

Scenario Two: Similar Acquisition Target

The executive in Scenario Two took the material, nonpublic information that an acquisition of Company X, by Company Y, was imminent and purchased stock in Company Z, the corporation's biggest competitor.¹⁴⁶ The executive did this anticipating that when the news was released, the biggest competitor's stock price would rise as it would be a target for a similar acquisition. The executive also should have reasonably known that the CEO expects her to keep the news of the acquisition

145. See *supra* Section II.A.1.

146. See *supra* Section II.A.2.

confidential as that information will affect their own company significantly and had not yet been disclosed to the public.

Similar to Scenario One, proposed Rule 10b5-2(b)(4) captures this shadow trade as well because the executive traded on material, nonpublic information that she could reasonably expect to affect her company's biggest competitor and was expected to keep that information in confidence. The language of "the equity, earnings, cash flows, market value, financial condition, future prospects, or stock price of a closely related company" included in proposed Rule 10b5-2(b)(4) allows for regulators to consider market size in shadow trades similar to Scenario Two.

If the executive in Scenario Two worked at a small clothing line, she would not be liable for insider trading under proposed Rule 10b5-2(b)(4). Because the clothing market is so vast and diverse the acquisition of one clothing line does not create a reasonable expectation that any clothing lines will follow nor create accurate indicia of which clothing lines would be up for a similar acquisition the same way it would in a small market.

Scenario Three: Bankrupt Competitor

The executive in Scenario Three took the material, nonpublic information that Tech Company One was going bankrupt and purchased stock in the corporation's biggest and only competitor.¹⁴⁷ The executive did this anticipating that when the bankruptcy news was released, the competitor's stock price would rise. The executive also should have reasonably known that the CEO expects him to keep the news of bankruptcy confidential as that information will affect their own company significantly and had not yet been disclosed to the public.

Similar to Scenarios One and Two, Rule 10b5-2(b)(4) captures this shadow trade because the executive traded on material, nonpublic information that he could reasonably expect to affect his company's biggest competitor and was expected to keep that information in confidence. Similarly to Scenario Two, the language of Rule 10b5-2(b)(4) allows for consideration of market size. Here, if the executive in Scenario Three worked at a company in a large market, they would not be liable for insider trading. This is because in a vast market one bankruptcy does not create nearly the same effect on competitors compared to Scenario Three where there was only a single competitor in the market.

147. See *supra* Section II.A.3.

CONCLUSION

When done in specific circumstances, shadow trading allows for the exact minimal-risk trades courts have spent decades crafting common law trying to prevent. The cleverness of those seeking significant gains with minimal risks has allowed them to abuse a loophole in insider trading law. Until this loophole is closed, shadow traders are one step ahead of current regulations. “[I]nvestors do not expect the playing field to be level, but they do expect that those who ‘have special access to information, because of employment or other relationships, should be barred from using that information to gain an advantage over the rest of us.’”¹⁴⁸ In an attempt to close this loophole, a broader and more aggressive reading of the common law to capture shadow trading would only contribute to continuing insider trading law’s “topsy-turvy” development.¹⁴⁹ Amending Rule 10b5-2 to include a fourth circumstance in which a duty of trust in confidence exists would close the loophole that currently permits shadow trading in a much clearer and more concise manner.

148. SEC v. Talbot, 530 F.3d 1085, 1097 (9th Cir. 2008) (quoting Barbara Bader Aldave, *Misappropriation: A General Theory of Liability for Trading on Nonpublic Information*, 13 HOFSTRA L. REV. 101, 123 (1984) (comparing trading in a market with insiders misappropriating information to playing a game against someone with loaded dice)).

149. See Quigley, *supra* note 50, at 188 (citing United States v. Whitman, 904 F. Supp. 2d 363, 372 (S.D.N.Y. 2012) (Rakoff, J.) (remarking on “the topsy-turvy way the law of insider trading has developed in the courts”), *aff’d*, 555 F. App’x 98 (2d Cir. 2014)).