Catholic University Law Review

Volume 72
Issue 3 *Summer 2023*

Article 8

8-11-2023

The *Panuwat* Snowball: Correlation Does Not Equal Materiality

Tanner Gattuso
tannerjgattuso@gmail.com

Follow this and additional works at: https://scholarship.law.edu/lawreview

Part of the Securities Law Commons

Recommended Citation
Tanner Gattuso, *The Panuwat Snowball: Correlation Does Not Equal Materiality*, 72 Cath. U. L. Rev. 415 (2023).
Available at: https://scholarship.law.edu/lawreview/vol72/iss3/8

This Comments is brought to you for free and open access by Catholic Law Scholarship Repository. It has been accepted for inclusion in Catholic University Law Review by an authorized editor of Catholic Law Scholarship Repository. For more information, please contact edinger@law.edu.

The *Panuwat* Snowball: Correlation Does Not Equal Materiality

Cover Page Footnote

J.D. Candidate, May 2023, The Catholic University of America, Columbus School of Law; B.S. 2020, The Pennsylvania State University. A special thank you to Professor Jack Murphy for his assistance guiding me through a new area of law and to my parents, Jim and Kristin Gattuso, for their unconditional support.

This comments is available in Catholic University Law Review: https://scholarship.law.edu/lawreview/vol72/iss3/8

THE PANUWAT SNOWBALL: CORRELATION DOES NOT EQUAL MATERIALITY

Tanner Gattuso[+]

Insider trading is a term of art referencing the fraudulent practice of trading securities in a company on the basis of material, nonpublic information about that same company in breach of some duty owed to another. The practice erodes the public's trust in theintegrity of our capital markets for a reason that is rather intuitive: it is inherently unfair to allow an individual to make a quick and certain profit by exploiting material, nonpublic information to which he privy due solely to his position in a company or some other relationship of trust and confidence. In this context, unrelenting civil enforcement by the Securities and Exchange Commission ("SEC") is surely warranted. But, what if an individual in possession of material, nonpublic information about one company trades in the securities of a different company? Is a civil enforcement action warranted in this context? This question is derived from the novel "shadow trading" theory of insider trading liability proffered by the SEC in its August 2021 civil enforcement action against Matthew Panuwat.

Judicial endorsement of the SEC's shadow trading theory presents concerning doctrinal and practical implications. First, it upends the traditional materiality inquiry required in an insider trading action. Second, it transforms Rule 10b-5—the SEC's primary enforcement mechanism—into a rule without limitation. Third, it will increase the cost of executing securities transactions as investors in possession of material, nonpublic information about one company could be required to abstain from trading in an endless list of companies, industries, and investment vehicles. Taken together, these considerations compel the rejection of the SEC's shadow trading theory of insider trading liability.

[+] J.D. Candidate, May 2023, The Catholic University of America, Columbus School of Law; B.S. 2020, The Pennsylvania State University. A special thank you to Professor Jack Murphy for his assistance guiding me through a new area of law and to my parents, Jim and Kristin Gattuso, for their unconditional support.

I. BRIDGING THE GAP: RULE 10B-5, INSIDER TRADING LIABILITY, AND MATTHEW PANUWAT 422
A. Rule 10b-5: The SEC's Weapon of Choice 422
B. *A Duty to Whom?* 424
C. The Main Event: The "Materiality" Inquiry 427
II. NOT YOUR TYPICAL INSIDER TRADING CASE 429
A. There's a First Time for Everything 429
B. Casting a Light on Shadow Trading 431
III. SEC V. PANUWAT 433
A. Panuwat's Flashlight: A Weak Correlation 433
B. Panuwat's Promise 437
IV. THE PANUWAT SNOWBALL 438
A. The Rule Without Limits 438
B. Increasing Liability Exposure Through Investment Risk Reduction 440
CONCLUSION 442

On December 27, 2001, while on her private jet flying to Mexico, Martha Stewart, one of America's most celebrated homemakers, received a call from her stockbroker: ImClone Systems was "going to start trading downward."[1] Stewart instructed her stockbroker to sell her 3,928-share position in ImClone Systems.[2] The next day, the Food and Drug Administration announced that it would not approve ImClone Systems' cancer drug, Erbitux, sending the company's stock price tumbling eighteen percent.[3] Stewart's decision yielded her nearly $230,000 in proceeds with $45,673 in avoided losses.[4] In essence, this high-profile scenario captures what is colloquially known as "insider trading" —that is, trading the securities of a public company based on material, nonpublic information about that same company.[5] But, what if an individual purchases or sells the securities of one company based on material, nonpublic information about *a different company*? Do such trades warrant a knock on the door from the Securities and Exchange Commission ("SEC")? Should they? This Comment will explore these questions below.

In 1934, Congress passed the Securities Exchange Act of 1934 ("Exchange Act"),[6] which was designed, *inter alia*, to protect investors from stock price

1. Joan M. Heminway, *Martha Stewart and the Forbidden Fruit: A New Story of Eve*, 2009 MICH. ST. L. REV. 1017, 1024 (2009). Stewart's broker, Peter Bacanovic, learned that ImClone Systems CEO Sam Waksal was attempting to sell all of his ImClone shares. *Id.* By conveying this information to Stewart, Bacanovic breached his duty of trust and confidence owed to Merrill Lynch, his employer. *Id.* at 1027. Note, however, that the conduct of Stewart and Bacanovic illustrates the tipper-tippee theory of insider trading liability—a theory of liability not further discussed in this Comment. For a discussion of tipper-tippee liability, *see* Thomas Lee Hazen, *Treatise on the Law of Securities Regulation* § 12:167 (Dec. 2022 Update).

2. *Id.* at 1023–24.

3. The Associated Press, *Timeline of Events in Stewart Stock Scandal*, CHI. TRIB. (Mar. 4, 2005, 7:59AM), https://www.chicagotribune.com/sns-ap-martha-stewart-chronology-story.html.

4. U.S. SEC. & EXCH. COMM'N, *SEC Charges Martha Stewart, Broker Peter Bacanovic with Illegal Insider Trading* (June 4, 2003), https://www.sec.gov/news/press/2003-69.htm; *Did Martha Stewart Miss Big Payout on ImClone?*, CNBC (July 31, 2008), https://www.cnbc.com/id/25950310.

5. *See* SEC v. Obus, 693 F.3d 276, 284 (2d Cir. 2012) ("Insider trading—unlawful trading in securities based on material nonpublic information—is well established as a violation of section 10(b) of the [Exchange Act] and Rule 10b-5."). Stewart was not ultimately convicted of violating federal securities laws and instead settled with the Securities and Exchange Commission ("SEC"). *Martha Stewart and Peter Bacanovic Settle SEC's Insider Trading Charges,* U.S. SEC. & EXCH. COMM'N (Aug. 7, 2006), https://www.sec.gov/news/press/2006/2006-134.htm. Stewart was, however, convicted of making false statements to investigators, perjury, conspiracy, and obstruction of justice. *See* United States v. Stewart, 323 F. Supp. 2d 606, 610 (S.D.N.Y. 2004), *aff'd*, 433 F.3d 273 (2d Cir. 2005).

6. Ch. 404, 48 Stat. 881 (codified as amended at 15 U.S.C. §§ 78a *et seq*).

manipulation.[7] Specifically, Section 10(b) of the Exchange Act provides, in relevant part, as follows:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange–
>
> ….
>
> (b) [t]o use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, or any securities-based swap agreement, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.[8]

As evinced by its own terms, "Section 10(b) does not . . . make any practice unlawful unless the SEC has adopted a rule prohibiting it."[9]

In an exercise of its statutory authority, the SEC promulgated Rule 10b-5 in 1942—a regulation many consider to be the SEC's most encompassing anti-fraud provision.[10] Tracking the language in Section 17(a) of the Securities Exchange Act of 1933,[11] Rule 10b-5 declares:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> (a) [t]o employ any device, scheme, or artifice to defraud,
>
> (b) [t]o make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading, or
>
> (c) [t]o 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.[12]

Unlike the Exchange Act, which has ample legislative history accompanying its enactment and subsequent amendment, Rule 10b-5 was adopted without any official deliberation.[13] Clearly, however, Rule 10b-5 was intended to serve as a

---

7. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 195 (1976). The Exchange Act also established the SEC, empowering it to "make such rules and regulations as may be necessary or appropriate to implement [its] provisions . . . ." 15 U.S.C. §§ 78d(a), 78w(a)(1).

8. 15 U.S.C. § 78j(b).

9. Sec. & Exch. Comm'n v. Clark, 915 F.2d 439, 443 (9th Cir. 1990).

10. *See* 17 C.F.R. § 240.10b-5; THOMAS L. HAZEN, THE LAW OF SECURITIES REGULATION 465 (8th ed. 2020).

11. *See* Ch. 38, § 17(a), 48 Stat. 74, 84–85 (codified as amended at 15 U.S.C. § 77(q)).

12. § 240.10b-5.

13. *See* HAZEN, *supra* note 10. According to at least one account, the only discussion even remotely resembling official deliberation was then-SEC Commissioner Sumner Pike remarking,

bridge between Congress' intent to protect investors and the execution of this intent.[14]

Insider trading has traditionally been understood to occur in those situations where "a corporate insider trades in the securities of his corporation on the basis of material, nonpublic information."[15] In the past, the SEC has characterized its initiation of enforcement actions against individuals who trade on inside information as being "essential" to preserving the confidence of public investors.[16] Ironically, there is no provision in the Exchange Act—or any statutory provision for that matter—expressly prohibiting insider trading. Rather, the SEC uses Rule 10b-5 as its primary enforcement mechanism.[17] Consequently, the American judicial system has created a body of federal common law with respect to insider trading based on judicial interpretations of Rule 10b-5.[18]

On August 17, 2021, the SEC began its attempt to further broaden the scope of Rule 10b-5 when it filed a complaint against Matthew Panuwat, alleging Panuwat engaged in insider trading.[19] Panuwat is a former "business development executive at Medivation Inc. ("Medivation"), a mid-sized oncology-focused biopharmaceutical company."[20] In its complaint, the SEC alleged that Panuwat was involved in high-level discussions exploring Medivation's options in light of it becoming an acquisition target.[21] These discussions included Panuwat's review of presentations created by investment bankers, which detailed companies they deemed to be comparable to

---

"we are against fraud, aren't we?" *Id.* (citing Remarks of Milton Freeman, in Conference on Codification of the Federal Securities Laws, 22 BUS. LAW. 793, 922 (1967)).

14. *See id.* ("[I]t is clear that not much can be gleaned from the history of the rule, although the courts frequently refer to the legislative history behind the statute. The clear purpose of Rule 10b-5 is to protect investors from being duped into purchasing or selling securities.").

15. United States v. O'Hagan, 521 U.S. 642, 651–52 (1997). The SEC Staff has described it as the trading that takes place based on confidential information used to "reap profits or avoid losses" to the detriment of the typical investors and the confidential information's source. Thomas C. Newkirk, Assoc. Dir. & Melissa A. Robertson, Senior Couns., Div. of Enf't, U.S. Sec. & Exch. Comm'n, Remarks at the 16th International Symposium on Economic Crime: Insider Trading – A U.S. Perspective, (Sept. 19, 1998), https://www.sec.gov/news/speech/speecharchive/1998/spch221.htm [hereinafter Newkirk & Robertson].

16. Newkirk & Robertson, *supra* note 15. Even though this speech was delivered in 1998, the sentiment has not changed; in a December 2022 press release, the SEC announced that it adopted amendments narrowing the scope of Exchange Act Rule 10b5-1, which operates as an affirmative defense to insider trading violations. *See SEC Adopts Amendments to Modernize Rule 10b5-1 Insider Trading Plans and Related Disclosures,* U.S. SEC. & EXCH. COMM'N (Dec. 14, 2022), https://www.sec.gov/news/press-release/2022-222.

17. Newkirk & Robertson, *supra* note 15.

18. HAZEN, *supra* note 10, at 518.

19. *See* Complaint ¶ 1, Sec. & Exch. Comm'n v. Panuwat, No. 4:21-cv-06322 (N.D. Cal. Aug. 17, 2021), [hereinafter "Panuwat Complaint"].

20. *Id.*

21. *Id.* ¶ 21.

Medivation.[22] Of particular relevance was the comparison to Incyte Corporation ("Incyte"), another mid-cap oncology-focused biopharmaceutical company.[23] The SEC further alleged that around July and August of 2016, Panuwat was involved in Medivation's inquiry into whether any larger pharmaceutical companies would be interested in acquiring Medivation.[24]

Panuwat allegedly knew that in 2015 large-cap pharmaceutical companies acquired mid-cap oncology-focused biopharmaceutical companies and that the large-cap pharmaceutical companies were interested in extending their shopping sprees of the same into 2016.[25] This, in turn, made any remaining mid-cap oncology-focused biopharmaceutical companies more valuable.[26] In August of

---

22. *Id.* ¶ 22.

23. *Id.*

24. *Id.* ¶¶ 24–25. As Medivation solicited bids from potential acquirers, Panuwat was involved in discussions relating to "the potential acquirers' due diligence and share-price bids." *Id.* ¶ 25.

25. *Id.* ¶ 22. The trend is well documented; in 2015 alone, 468 pharmaceutical deals were announced. Laura J. Vitez & Richard K. Harrison, *Trends in Pharmaceutical Mergers and Acquisitions*, NATURE (Dec. 8, 2016), https://www.nature.com/articles/d43747-020-00209-x. This figure represents a 90% increase over pharmaceutical deal activity in 2012—a ten-year industry low. *Id.* The increase in pharmaceutical merger and acquisition activity between 2015 and 2016 was driven in large part by the desires of large-cap pharmaceutical companies to bolster innovation within the realm of breakthrough immuno-oncology drugs. *See id*; Roerich Bansal, *What's Behind the Pharmaceutical Sector's M&A Push*, MCKINSEY & CO. (Oct. 10, 2018), https://www.mckinsey.com/business-functions/strategy-and-corporate-finance/our-insights/whats-behind-the-pharmaceutical-sectors-m-and-a-push. The wisdom underlying this industry dynamic is quite practical. For context, a pharmaceutical company must invest significant amounts of money in marketing and distribution in order to obtain the maximum value from its blockbuster drugs. Barak Richman et al., *Pharmaceutical M&A Activity: Effects on Prices, Innovation, and Competition*, 48 LOY. U. CHI. L.J. 787, 791 (2017). Such expenditures are sunk costs that cannot be recouped once patent protection for the blockbuster drug expires. *Id.* If a biopharmaceutical company's blockbuster drug loses patent protection, and it has no other drugs within its development pipeline to replace the blockbuster drug, then the biopharmaceutical company must look to—and ultimately acquire—small-cap pharmaceutical companies to fill this void or else develop a new drug itself. *Id.* at 791–92. Large-cap pharmaceutical companies generally prefer the acquisition route from a strategic perspective because drug development entails a high degree of risk. Roerich Bansal, *What's Behind the Pharmaceutical Sector's M&A Push*, MCKINSEY & CO. (Oct. 10, 2018), https://www.mckinsey.com/business-functions/strategy-and-corporate-finance/our-insights/whats-behind-the-pharmaceutical-sectors-m-and-a-push. Specifically, in the beginning of the development process, early-stage drugs require high levels of investment despite a low probability of success. *Id.* Similarly, drugs in later stages still require high levels of investment in order to navigate a complex regulatory approval scheme. *Id.* In effect, this dynamic has created an industry of large-cap pharmaceutical companies "window-shopping" for promising drugs produced by small-cap pharmaceutical companies. *Id.* In 2015 and 2016, the "promising drugs" driving acquisition activity were immuno-oncology drugs. *See* Laura J. Vitez & Richard K. Harrison, *Trends in Pharmaceutical Mergers and Acquisitions*, NATURE (Dec. 8, 2016), https://www.nature.com/articles/d43747-020-00209-x. Here, the SEC alleges the acquisition of any of the remaining mid-cap oncology-focused biopharmaceutical companies—or at least information of a potential acquisition—was material to all of the remaining companies and that Panuwat was aware of this. Panuwat Compl. ¶ 22.

26. Panuwat Compl. ¶ 22.

2016, Panuwat obtained nonpublic information through the course of his employment that "Medivation was going to be imminently acquired at a significant premium."[27] On August 18, Panuwat received an email from Medivation's CEO indicating that Medivation was going to be acquired by Pfizer, Inc. ("Pfizer").[28] Minutes after receiving this email, "Panuwat logged onto his personal brokerage account from his work computer and purchased 578 [out-of-the-money] Incyte call option[s]" set to expire on September 16, 2016.[29]

On August 22, Medivation publicly announced its imminent acquisition by Pfizer "at a price of $81.50 per share, a 21.4% premium over its closing price of $67.16 per share" just three days earlier.[30] By close of market that day, the stock prices of Medivation and Incyte rose 20% and 8%, respectively.[31] Panuwat exercised his call options, realizing a profit of $107,066.[32] Thus, the SEC's allegations squarely present the novel question of whether one violates Rule 10b-5 by *shadow trading*—that is, trading securities of one company based on material, nonpublic information about a different, but similarly situated company in the same industry.[33]

This Comment explores the legal ramifications of the SEC's latest attempt to broaden the scope of Rule 10b-5 by seeking to impose insider trading liability on Matthew Panuwat based on a shadow trading theory. Part I discusses the judicial interpretations of Section 10(b) and Rule10b-5 as they relate to the theories of insider trading liability. Part II reviews the pertinent facts of *Securities & Exchange Commission v. Panuwat*, defines the concept of shadow trading, and identifies which elements of a Rule 10b-5 cause of action, if any,

---

27. *Id.* ¶ 26. This awareness is the product of a variety of alleged events: (1) Panuwat receiving a summary of at least five all-cash acquisitions on August 12, 2016; (2) Panuwat's attendance at a Medivation board of directors meeting on August 14, 2016, where Medivation's investment bankers were authorized to send letters to the remaining bidders soliciting final merger agreement comments; (3) Panuwat was emailed confidential copies of the proposed letters prior to August 14, 2016; (4) Panuwat received emails indicating Medivation's potential acquirers were eager to move "forward with an acquisition quickly and that August 22, 2016 was the target date for a public announcement of the acquisition"; and (5) Medivation's CEO sent Panuwat, among other executives, an email detailing Pfizer's "overwhelming interest" in acquiring Medivation and that final details were being worked out. *Id.* ¶ 27–30.

28. *Id.* ¶ 30.

29. *Id.* ¶ 33. Call options are contracts that give the holder the right but not the obligation to purchase the underlying stock at a set price (strike price) on or before the expiration date. Jim Probasco, *What Is a Call Option?*, BUS. INSIDER (Sept. 21, 2022, 11:08 AM), https://www.businessinsider.com/call-option. Panuwat's Incyte call options had strike prices of $80, $82.50, and $85 per share, despite Incyte only trading at $76 to $77 per share at the time. Panuwat Compl. ¶ 33. Panuwat was aware there would be no earnings announcement by Incyte between when he bought the call options and when they were set to expire. *Id.*

30. *Id.* ¶ 36.

31. *Id.* ¶¶ 36–37. Other mid-cap biopharmaceutical companies' stock prices also increased that day. *Id.* ¶ 37.

32. *Id.* ¶ 38.

33. Mihir N. Mehta et al., *Shadow Trading*, ACCT. REV., at 1 (2020).

may prove problematic to the SEC's novel theory of insider trading liability. Part III applies the judicial interpretations of Section 10(b) and Rule 10b-5 to the facts of *Panuwat* and analyzes the strengths and weaknesses in the SEC's shadow trading theory. Finally, Part IV explores the implications of the SEC's shadow trading theory on its future enforcement of Rule 10b-5 and on investment strategies generally.

I. BRIDGING THE GAP: RULE 10B-5, INSIDER TRADING LIABILITY, AND MATTHEW PANUWAT

A. Rule 10b-5: The SEC's Weapon of Choice

The SEC has been able to weaponize Section 10(b) through Rule 10b-5 to prosecute individuals for insider trading primarily because of the way in which Section 10(b) is drafted.[34] First, Section 10(b) applies to any purchase or sale of any security.[35] Because of Congress' use of the word "any" in drafting Section 10(b), the Supreme Court broadly construed the provision's application to extend to all transactions in securities utilizing an instrumentality of interstate commerce without exception.[36] Similarly, "instrumentalities of interstate commerce" has been interpreted broadly: "All that is required is that [the transaction] be used or employed in connection with the use of the instruments of interstate commerce or the mails."[37] Even a purchase or sale of a security executed entirely intrastate does not spare an individual from potential liability if any communications incidental to the transaction were conducted using the instrumentalities of interstate commerce, such as via a telephone, e-mail, or a text message.[38] Further, Section 10(b) and Rule 10b-5 contain "notoriously vague" terminology—words like "fraud," "deceit," and "device, scheme, or artifice"—which further enables application to a wide variety of trading practices.[39] Section 10(b)'s broad drafting is something the SEC patently

34. Newkirk & Robertson, *supra* note 15; *see also* Sec. & Exch. Comm'n v. Clark, 915 F.2d 439, 448 (9th Cir. 1990).

35. *See* 15 U.S.C. § 78j(b).

36. *See* Affiliated Ute Citizens of Utah v. United States, 406 U.S. 128, 151 (1972) (noting that the repeated use of the word "any" in Section 10(b) and Rule 10b-5 is "obviously meant to be inclusive" of a wide range of practices).

37. Stevens v. Vowell, 343 F.2d 374, 378–79 (10th Cir. 1965); *see, e.g.,* Dupuy v. Dupuy, 511 F.2d 641, 643–44 (5th Cir. 1975) (holding that intrastate use of the telephone may confer federal jurisdiction); United States v. Porter, 441 F.2d 1204, 1211 (8th Cir. 1971) (emphasizing that even mailings incidental to the fraud itself are still sufficient). "Interstate commerce," as used in the Exchange Act and referenced in the cases cited *supra*, means "trade, commerce, transportation, or communication among the several States, or between any foreign country and any State, or between any State and any place or ship outside thereof." 15 U.S.C. § 78c(a)(17). "Interstate commerce" also includes "intrastate use of (A) any facility of a national securities exchange or of a telephone or other interstate means of communication, or (B) any other interstate instrumentality." *Id.*

38. *See Stevens*, 343 F.2d at 378–79; *Dupuy*, 511 F.2d at 643–44; *Porter*, 441 F.2d at 1204.

39. *Clarke*, 915 F.2d at 448.

acknowledges.[40] Indeed, senior SEC officials credit Section 10(b)'s broad and vague language for providing it with "the flexibility to meet new schemes and contrivances head on."[41]

However, there is one term in particular to which federal courts routinely decline to impute a broad reading: "manipulative."[42] In *Santa Fe Industries, Inc. v. Green*, the Supreme Court characterized Section 10(b)'s prohibition of "manipulative" practices as a "term of art" to be interpreted in the technical sense—namely, the employment of a means to "artificially affect[ ] market activity in order to mislead investors."[43] Further clarifying when any particular activity is sufficiently "manipulative" so as to trigger the application of Section 10(b), the Second Circuit explained:

> Although not explicitly described as such, case law in this circuit and elsewhere has required a showing that an alleged manipulator engaged in market activity aimed at deceiving investors as to how other market participants have *valued a security*. The deception arises from the fact that investors are misled to believe "the prices at which they purchase and sell securities are determined by the natural interplay of supply and demand, not rigged by manipulators."[44]

Thus, the scope of Section 10(b) is simultaneously narrow and broad; it targets a very specific type of conduct across a seemingly endless array of securities transactions and trading practices.

Federal courts have applied this understanding of Section 10(b) to their interpretations of Rule 10b-5. Specifically, a violation of Rule 10b-5 requires a showing—whether it be in an SEC civil enforcement action or criminal prosecution[45]—that "the defendant (1) made a false statement or omission (2) of material fact (3) with scienter (4) in connection with the purchase or sale of securities."[46] In the context of a civil enforcement action, the burden is on the

---

40. Newkirk & Robertson, *supra* note 15.

41. *Id.*

42. *See* Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 476 (1977).

43. *Id.* at 476–77.

44. ATSI Commc'ns., Inc. v. Shaar Fund, Ltd., 493 F.3d 87, 100 (2d Cir. 2007) (quoting Gurary v. Winehouse, 190 F.3d 37, 45 (2d Cir. 1999)).

45. The Supreme Court has also interpreted Section 10(b) and Rule 10b-5 to include an implied private right of action, despite there being no express statutory right. *See* Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 11–12 (1971).

46. Sec. & Exch. Comm'n v. Pirate Inv. LLC, 580 F.3d 233, 239 (4th Cir. 2009); *cf.* Lawrence v. Cohn, 325 F.3d 141, 147 (2d Cir. 2003) (emphasis added):

> In order to state a claim for securities fraud under Section 10(b) of the Exchange Act and Rule 10b-5 promulgated by the SEC thereunder . . . a plaintiff must establish that 'the defendant, in connection with the purchase or sale of securities, made a materially false statement or omitted a material fact, with scienter, and that the plaintiff's *reliance on the defendant's action caused injury to the plaintiff*.'

Thus, the key difference between an SEC civil enforcement and a private right of action under Rule 10b-5 is that the SEC *does not* need to prove reliance or causation. *See* Sec. & Exch. Comm'n v.

SEC to establish each element by a preponderance of the evidence.[47]

B. A Duty to Whom?

The term "insider trading" does not refer solely to illegal trading activity but encompasses legitimate trading practices, as well.[48] Insider trading is considered illegal only when an individual "buys or sells a security, in a breach of a fiduciary duty or other relationship of trust and confidence, while in the possession of material, nonpublic information."[49]

Impliedly, the concept of insider trading raises two important questions: what duty, if any, does a holder of material, nonpublic information owe and to whom does this duty extend? The SEC first addressed this matter in *In re Cady, Roberts & Co.*, where it held that corporate insiders must either disclose the material, nonpublic information they possess or else abstain from trading in the shares of the corporation.[50] This holding is what is commonly referred to as the "disclose or abstain" rule.[51] According to the SEC, the disclose or abstain rule is based on:

> An affirmative duty to disclose material information[, which] has been traditionally imposed on corporate "insiders," particular officers, directors, or controlling stockholders. [The SEC] and the courts have consistently held that insiders must disclose material facts which are known to them by virtue of their position but which are not known to persons with whom they deal and which, if known, would affect their investment judgment.[52]

The disclose or abstain rule derives from a practical understanding of how a corporate insider comes into possession of the material, nonpublic information intended solely for corporate purposes in the first place: by reason of his or her

---

Rana Rsch., Inc., 8 F.3d 1358, 1364 (9th Cir. 1993); Sec. & Exch. Comm'n v. Blavin, 760 F.2d 706, 711 (6th Cir. 1985).

47. *Pirate Inv.*, 580 F.3d at 239.

48. 14 RANDY M. MASTRO & LEE G. DUNST, BUS. & COM. LITIG. FED. CTS. § 153:32 (5th ed. 2021). Insider trading is considered legal in circumstances where corporate insiders trade stock in their own companies and report their trades to the SEC. *Id.*; Mark J. Astarita, *Insider Trading – The Legal and Illegal*, SECLAW.COM, https://www.seclaw.com/insider-trading/ (last visited Feb. 22, 2022). When timely reported, the trading activity of corporate insiders is considered important information by some traders and investors on the theory that it serves as a proxy for the health of the company. Mark J. Astarita, *Insider Trading – The Legal and Illegal*, SECLAW.COM, https://www.seclaw.com/insider-trading/ (last visited Feb. 22, 2022). Insider trading is also considered legal when done in accordance with 10b-5 plans, which are specific procedures designed to allow corporate insiders to sell stock at regular intervals, without regard to the company's performance at the time of sale. *Id.*

49. Mastro & Dunst, *supra* note 48 (internal citations omitted).

50.In re Cady, Roberts Co., 40 S.E.C. 907, 912 (1961).

51. *See* Wilson v. Comtech Telecomms. Corp., 648 F.2d 88, 94–95 (2d Cir. 1981) (referring to the duty to disclose or abstain as the "disclose or abstain" rule).

52. Chiarella v. United States, 445 U.S. 222, 227 (1980) (quoting *Cady, Roberts & Co.*, 40 S.E.C. 907 (1961)).

position with the company.[53] Accordingly, the SEC identified a fiduciary relationship between a corporate insider who obtains material, nonpublic information solely by virtue of his or her position with the company and the shareholders of that same company.[54] From this relationship, the Supreme Court recognized a corporate insider's duty to disclose arises because of the need to prevent them from exploiting material, nonpublic information at the expense of the company's uninformed shareholders.[55] Consequently, "Section 10(b) and Rule 10b-5 are violated when a corporate insider trades in the securities of his corporation on the basis of material, nonpublic information" about that same corporation.[56] This captures the "classical theory" of insider trading liability.[57]

But the duty to disclose applies only insofar as to those whom the corporate insider owes a fiduciary duty.[58] Therefore, it follows that an individual who is consummating a transaction to purchase or sell securities in a company is under no duty to disclose any material facts if the individual is neither a fiduciary nor a corporate insider.[59] The Supreme Court's decision in *Chiarella v. United States* exemplifies this point. In *Chiarella*, an employee of a financial printer company retained to print tender offer documents deduced the names of target companies from those documents.[60] Armed with this information, the printer acquired shares of the target companies.[61] Immediately after the takeover attempts went public, the printer liquidated his position, netting over $30,000 in profits.[62] In the aftermath of this trade, the printer was convicted of violating Section 10(b) and Rule 10b-5; his conviction was subsequently affirmed by the Second Circuit.[63] After granting certiorari, the Supreme Court considered whether the printer was under a duty to disclose the takeover information prior to trading on it.[64] The Court held that the printer was under no duty to disclose—nor does such a duty arise—from the mere possession of nonpublic market information.[65]

53. *See id.* at 227–28.

54. *Id.* at 228.

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

56. *Id*. at 651–52.

57. *Id.*

58. *Chiarella*, 445 U.S. at 229.

59. *Id.*

60. *Id.* at 224. It is important to note that the printer was charged with handling a document containing five announcements of takeover bids. *Id.* The identities of the acquiring and target companies were not readily ascertainable up until the night of final printing. *Id.* Here, the printer deduced the names of the target companies prior to the final printing. *Id.*

61. *Id.*

62. *Id.*

63. *Id.* at *225*.

64. *Id.* at 231, 234.

65. *Id.* at 235. The Court in *Chiarella* specifically did not decide whether the printer's breach of duty to the acquiring corporation by trading upon information that he obtained as an employee

In support of its holding, the Supreme Court analyzed the printer's relationship with the target companies.[66] Specifically, the Court noted that the printer "was not a corporate insider and he received no confidential information from the target compan[ies]," but rather was a stranger who only dealt with the sellers at arm's length.[67] Without a sufficient nexus between the printer and the target companies, the Court determined that no duty could arise, and with no duty to disclose, the use of such material, nonpublic information did not violate Section 10(b) or Rule 10b-5.[68]

After *Chiarella*, another theory of insider trading liability developed: the "misappropriation theory."[69] Unlike the classical theory, which identifies a fiduciary relationship between the corporate insider and company shareholders warranting the corporate insider's duty to disclose material, nonpublic information before trading, the misappropriation theory premises liability on a "breach of a duty *owed to the source* of the material, nonpublic information."[70] The misappropriation theory was designed to target those *outsiders* who have access to material, nonpublic information about a corporation, despite owing no duty to that corporation's shareholders.[71]

In *United States v. O'Hagan*, the Supreme Court applied the misappropriation theory of insider trading liability.[72] There, a law firm represented a London-based company regarding a potential acquisition of another company.[73] While the law firm was still representing the London-based company, a lawyer at the firm, who was not involved in the firm's representation, learned of the proposed acquisition and began purchasing call options and common stock in the target company.[74] When news broke of the London-based company's tender offer,

---

of the printer would support a violation of Section 10(b) and Rule 10b-5 because the theory had not been submitted to the jury that convicted Chiarella. *Id.* at 235–36.

66. *Id.* at 224.

67. *Id.* at 231–33.

68. *Id.* at 231–32. Allegations of fraud based upon nondisclosure cannot exist absent a duty to disclose. *Id.* at 235. However, being a corporate insider is not a requisite to insider trading liability under the "classical theory"; federal courts have extended the duty to disclose to those individuals they deemed to be "temporary fiduciaries" of a corporation. *See* O'Hagan, 521 U.S. at 652.

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

70. *Id.*

71. *Id.* at 653. The "misappropriation theory" satisfies Section 10(b)'s requirement that there be "deceptive" conduct because an individual defrauds the principal of the information by using it for their personal gain. *Id.* at 653–54. Likewise, such conduct is deemed to be "in connection with the purchase or sale of [a] security" because the fraud commences when the individual uses that information to purchase or sell securities without first disclosing his intention to the principal. *Id.* at 655–56.

72. *See generally id.*

73. *Id.* at 647.

74. *Id.* The lawyer owned 2,500 unexpired call options—more than any other individual investor at that time. *Id.* The lawyer also purchased about 5,000 shares in the target company's common stock at $39 per share. *Id.* at 648.

which occurred after the lawyer's transactions, the target company's stock price rose to $60 per share from just under $39 per share.[75] Consequently, the lawyer realized $4.3 million in profit after selling his call options and common stock.[76] After an investigation into the lawyer's transactions, the lawyer was convicted of, *inter alia*, seventeen counts of securities fraud in violation of Section 10(b) based on the misappropriation theory of insider trading liability.[77] However, the Eighth Circuit reversed the trial court's decision, holding that insider trading liability could not be based on a misappropriation theory.[78] After granting certiorari, the Supreme Court reversed the Eighth Circuit, holding that an individual may violate Section 10(b) and Rule 10b-5 if he or she trades on material, nonpublic information in breach of a fiduciary duty to the source of said information.[79] Thus, the Court approved the government's theory of Section 10(b) liability: the lawyer owed a fiduciary duty to his law firm—the source of the material, nonpublic information—which he breached by purchasing securities on the basis of that information without disclosing his transaction to the law firm.[80]

C. The Main Event: The "Materiality" Inquiry

The disclose or abstain rule is only triggered, however, if the nonpublic information upon which a transaction is based is "material."[81] The nature of the modern inquiry into the materiality of information under federal securities laws was first set forth in the landmark decision of *TSC Industries, Inc. v. Northway, Inc.*[82] In *TSC Industries*, a joint proxy statement was asserted to be "incomplete and materially misleading in violation of Section 14(a) of the Securities Exchange Act of 1934" and Rule 14a-9 thereunder.[83] Facing the question of whether this omission was material, the Court explained the general standard of materiality as used in Section 14(a) as follows:

> An omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote. This standard . . . does not require proof of a substantial likelihood that disclosure of the omitted fact would have caused the reasonable investor to change his vote. What the standard does contemplate is a showing of a substantial likelihood that, under all the circumstances, the omitted fact would have assumed actual

75. *Id.*
76. *Id.*
77. *Id.* at 648–49.
78. *Id.* at 649.
79. *Id.* at 659.
80. *Id.* at 654.
81. *See* HAZEN, *supra* note 10, at 483 ("As is the case with scienter, the materiality and reliance requirements carry over to Rule 10b-5 actions.").
82. 426 U.S. 438 (1976).
83. *Id.* at 441.

> significance in the deliberations of the reasonable shareholder. Put another way, there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the "total mix" of information made available.[84]

Subsequently, the Supreme Court extended this standard of materiality to Section 10(b) and Rule 10b-5.[85] In doing so, the Court made clear that the materiality inquiry is not a bright-line test.[86] Rather, information is material "if there is a substantial likelihood that a reasonable investor would consider it important to deciding how to invest."[87]

The application of the materiality standard as announced in *TSC Industries* and applied in subsequent cases, however, presumes a high degree of certainty in both the probability of the occurrence of the event and the extent of the impact of the event on the company to which the nonpublic information pertains.[88] And, of course, both the probability of an event's occurrence and the extent of its impact are not always readily ascertainable. As such, the materiality inquiry becomes complicated when the nonpublic information is speculative or contingent in nature because it is difficult to determine whether a reasonable investor would consider the nonpublic information material because of the inherent uncertainties.[89]

This issue was presented in *Basic Inc. v. Levinson*, where the Court was tasked with ascertaining the materiality of preliminary merger discussions.[90] The Court explained that the materiality of speculative information "'will depend at any given time upon the balancing of both the indicated probability that the event will occur and the anticipated magnitude of the event in light of the totality of the company activity.'"[91] In so stating, the Court fashioned a holistic, fact-dependent approach to determining the materiality of speculative information: the "probability/magnitude" test.[92] The Court provided the following guidance when applying this test:

---

84. *Id.* at 449.

85. Basic Inc. v. Levinson, 485 U.S. 224, 232 (1988).

86. *See id.* at 236 ("A bright-line rule is indeed easier to follow than a standard that requires the exercise of judgment in the light of all the circumstances. But the ease of application alone is not an excuse for ignoring the purposes of the securities acts and Congress' policy decision.").

87. Sec. & Exch. Comm'n v. Yang, 999 F. Supp. 2d 1007, 1011 (N.D. Ill. 2013) (citing *Basic*, 485 U.S. at 231). *Cf.* Sec. & Exch. Comm'n v. Tex. Gulf Sulphur Co., 401 F.2d 833, 848 (2d Cir. 1968) ("An insider's duty to disclose information or his duty to abstain from dealing in his company's securities arises only in 'those situations which are essentially extraordinary in nature and which are reasonably certain to have a substantial effect on the market price of the security if [the extraordinary situation is] disclosed.'").

88. *See Basic*, 485 U.S. at 232.

89. *Id.*

90. *Id.* at 230.

91. *Id.* at 238 (citing Tex. Gulf Sulphur Co., 401 F.2d at 849).

92. *Id.* at 239.

> Generally, in order to assess the probability that the event will occur, a factfinder will need to look to indicia of interest in the transaction at the highest corporate levels. Without attempting to catalog all such possible factors, we note by way of example that board resolutions, instructions to investment bankers, and actual negotiations between principals or their intermediaries may serve as indicia of interest. To assess the magnitude of the transaction to the issuer of the securities allegedly manipulated, a factfinder will need to consider such facts as the size of the two corporate entities and of the potential premiums over market value. No particular event or factor short of closing the transaction need be either necessary or sufficient by itself to render merger discussions material.[93]

Given that this inquiry is a balancing of an event's magnitude and the probability of the event's occurrence, "the greater the magnitude and the greater the probability of the event, the more likely it will be material."[94] But, a deficiency in either the probability of the event occurring or its magnitude does not render information immaterial per se. As Professor Thomas Hazen explains: "[R]elatively uncertain contingencies that would have a great impact on the company may be material. Conversely, a virtually certain event with substantially less significance may also be material. However, too much uncertainty will result in a finding of immateriality."[95]

II. Not Your Typical Insider Trading Case

A. *There's a First Time for Everything*

Panuwat presents a novel application of existing insider trading liability doctrine. "From September 2014 to January 2017, Matthew Panuwat worked in business development at Medivation."[96] Prior to his tenure at Medivation, Panuwat worked in investment banking in the San Francisco area.[97] Over the course of his career, Panuwat developed extensive expertise and knowledge with respect to the biopharmaceutical industry.[98]

In 2016, Panuwat was the Senior Director of Business Development at Medivation.[99] In that capacity, he was responsible for evaluating opportunities to grow the company.[100] Accordingly, Panuwat received nonpublic information

93. *Id.*

94. Hazen, *supra* note 10, at 489.

95. *Id.* at 489–90.

96. Panuwat Compl. ¶ 13.

97. *Id.*

98. *Id.* ¶ 14. Panuwat had fifteen years of experience "in the biopharmaceutical industry, including eight years in [] global healthcare investment banking . . . [and other experience] in business and strategic development." *Id.*

99. *Id.* ¶ 17.

100. *Id.* ¶ 18.

relating to "actual or potential acquisitions of or by Medivation."[101] Panuwat agreed he would maintain the confidentiality of any information he was provided and signed Medivation's insider trading policy.[102] Medivation's insider trading policy provided, in pertinent part, as follows:

> During the course of your employment . . . with the Company, you may receive important information that is not yet publicly disseminated . . . about the Company . . . . Because of your access to this information, you may be in a position to profit financially by buying or selling or in some other way dealing in the Company's securities . . . or the securities of another publicly traded company, including all significant collaborators, customers, partners, suppliers, or competitors of the Company . . . . For anyone to use such information to gain personal benefit . . . is illegal.[103]

Around April 2016, Medivation caught wind that other companies were interested in acquiring it and retained investment banks to advise it on a potential acquisition.[104] Panuwat was involved in this process.[105] During the course of Panuwat's work, he reviewed presentations detailing company comparison analyses, which included one presentation comparing Medivation to Incyte, another mid-cap oncology-focused company with a commercial-stage drug on the market.[106] Also around that time, a unique trend developed in the biopharmaceutical industry: large-cap pharmaceutical companies began increasingly "acquiring oncology-focused mid-cap biopharmaceutical companies with commercial-stage drugs."[107]

The SEC alleges Panuwat was not only aware of this trend, but also knew that there were only a few mid-cap oncology-focused companies left to acquire.[108] Moreover, the SEC alleges Panuwat knew that "each such acquisition was material to the remaining companies" because the market principles of supply and demand would naturally increase the value of remaining mid-cap companies.[109]

---

101. *Id.* ¶ 19.

102. *Id.* ¶ 20.

103. *Id.* (emphasis omitted).

104. *Id.* ¶ 21.

105. *Id.*

106. *Id.* ¶ 22. A comparable company analysis ("comp") is a relative valuation methodology that compares certain financial ratios of similar public companies in order to derive the value of another business. *What Is a Comparable Company Analysis?*, CORP. FIN. INST., https://corporatefinanceinstitute.com/resources/knowledge/valuation/comparable-company-analysis/ (last visited Oct. 24, 2021).

107. Panuwat Compl. ¶ 22; *see also supra* note 25.

108. Panuwat Compl. ¶ 22.

109. *Id.* In particular, the SEC alleges Panuwat knew that a prior acquisition of a 2015 mid-cap oncology-focused biopharmaceutical company "resulted in the material increase of the stock prices of both Medivation and Incyte." *Id.*

In August 2016, while still acting as the Senior Director of Business Development at Medivation, Panuwat learned that Medivation was going to be acquired by Pfizer in an all-cash bid at a significant premium to Medivation's stock price.[110] On August 18, 2016, Panuwat "purchased 578 Incyte call option contracts with strike prices of $80, $82.50, and $85 per share," set to expire on September 16, 2016, at a time when Incyte's stock price was trading around $77.[111] Panuwat did not disclose his trade to anyone at Medivation.[112]

On August 20, 2016, Medivation signed a merger agreement with Pfizer, whereby Pfizer would acquire Medivation at a price of $81.50 per share.[113] On August 22, 2016, before market open, Medivation publicly announced its merger with Pfizer and the details thereof.[114] At market open that same day, the stock price of Medivation jumped 20% from $67.16 to $80.62 per share.[115] Incyte's stock price also increased to $81.98 per share up from $76.11 per share, representing an 8% increase over the prior trading day's close.[116] Panuwat's Incyte call options netted him $107,066 in profit.[117]

What may not be evident is that the SEC's theory of insider trading liability is entirely novel. This is not your typical insider trading case. The factual allegations detail a different type of transaction. Specifically, the SEC alleges that Panuwat used the nonpublic information regarding Pfizer's imminent acquisition of Medivation, which was obtained because of his employment with Medivation, to then go and purchase call options in a *different*—albeit arguably comparable—mid-cap oncology-focused biopharmaceutical company.[118] As previously stated, this practice is referred to by researchers as shadow trading and will be explored in further detail below.

B. Casting a Light on Shadow Trading

Like the typical insider trading scenario, shadow trading begins with nonpublic information.[119] But that is where the material similarities end. Shadow trading is premised on the idea that "information held by insiders can also be relevant for economically-linked firms and exploited to facilitate profitable trading in those firms."[120] When nonpublic information about one company emerges, individuals who have access to that information have the

110. *Id.* ¶¶ 26–30.
111. *Id.* ¶ 33.
112. *Id.* ¶ 34.
113. *Id.* ¶ 35.
114. *Id.* ¶ 36.
115. *Id.*
116. *Id.* ¶ 37.
117. *Id.* ¶ 38.
118. *Id.* ¶¶ 1–5.
119. Mehta, *supra* note 33, at 1.
120. *Id.*

opportunity to then trade in the securities of an economically-linked company.[121] In other words, the nonpublic information about one company is not being used to purchase or sell the securities *of that same company*, but the securities of *a different company* that may be economically-linked, such as a business partner or industry competitor.[122]

While the SEC has not attempted to take civil action against an individual for shadow trading heretofore, there is evidence to suggest the presence of shadow trading in the market.[123] Mihir N. Mehta, David M. Reeb, and Wanli Zhao published an article in the September 2020 edition of *The Accounting Review*, reporting their findings as to the prevalence of shadow trading in the market.[124] In their article, they found that there is heightened trading activity in firms prior to public announcements of various material events of another firm to which the former is economically linked.[125]

Of relevance to *Panuwat* is the prevalence of shadow trading as it relates to the trading of securities of one company based on nonpublic information about an imminent acquisition of an economically linked company. The aforementioned study examined the trading activity of firms thirty days before the announcement of a merger from a company to which the prior firms are either business partners or competitors.[126] If the linked company and the announcing company were business partners, linked firms experienced statistically significant increases in trading activity.[127] Specifically, the study found that in the thirty days prior to a company publicly announcing an imminent merger or acquisition, trading activity in that company's business partners increased anywhere between 3.1% and 12%.[128] However, the evidence is not nearly as strong when the linked firm is a competitor of the announcing company.[129] While the results of this study may evince the *existence* of shadow trading in our capital markets, the study does not provide assistance in determining whether such trading is *actionable* under Section 10(b) and Rule10b-5.

Based on the nature of shadow trading, any merit to its successful application as a theory of insider trading liability turns on two inquiries—both of which were

---

121. *Id.*

122. See *id.*

123. *See generally id.*

124. *Id.*

125. *Id.* at 1–2. Material events include announcements regarding earnings, mergers and acquisitions, and new products. *Id.* at 2.

126. *Id.* at 17.

127. *Id.* at 2 n.3.

128. *Id.*

129. *Id.* at 18. The authors speculate that the weaker correlational results relating to trading activity in competitors of linked firms derive from the fact that "mergers have heterogeneous effects on competitors based on a merger's effect on market structure characteristics." *Id.*

recently raised by Panuwat in his motion to dismiss.[130] First, whether material, nonpublic information regarding one company is also "material" with respect to a similarly situated company that *may be* "economically-linked." Second, assuming the information is "material," whether the holder of the information has a duty to disclose the information prior to trading on it and to whom that duty extends.[131]

III. SEC v. Panuwat

A. *Panuwat's Flashlight: A Weak Correlation*

Insider trading liability can be imputed only when an individual purchases or sells a security on the basis of *material*, nonpublic information.[132] As stated above, "information is material if there is a substantial likelihood that a reasonable investor would consider it important to deciding how to invest."[133] This begs the question of whether a *reasonable investor* would have considered Pfizer's imminent acquisition of *Medivation* important to his or her decision to invest in *Incyte*. But this question presents another difficult application of the materiality standard for two reasons. First, like the preliminary merger discussions in *Basic*, the facts at issue present preliminary acquisition discussions, which, in turn, require the application of the probability/magnitude test. The SEC's shadow trading theory of liability, however, requires a determination of the magnitude of an acquisition not on the company to be acquired, but rather on a *competitor* of the company being acquired. Second, and incident to the novelty of the SEC's theory of liability, the relevant case law discussing the materiality of information regarding an imminent acquisition is inconclusive at best since the "issuer of the securities allegedly manipulated" was not a party to the acquisition.[134]

---

130. *See* Defendant's Notice of Motion and Motion to Dismiss, Sec. & Exch. Comm'n v. Panuwat, No. 21-cv-06322-WHO, at *9–12 (N.D. Cal. Aug. 17, 2021). In addition, Panuwat challenged the SEC's assertion that he acted with the requisite scienter. *See id.* at *12–15.

131. On January 14, 2022, Panuwat's motion to dismiss was denied in full because the court concluded that the SEC has sufficiently pleaded a Rule 10b-5 cause of action. *See* Order Denying Motion to Dismiss, Sec. & Exch. Comm'n v. Panuwat, No. 21-cv-06322-WHO (N.D. Cal. Aug. 17, 2021). While this ruling may indicate the court's openness to hearing the SEC's novel insider trading theory, it is by no means a conclusive finding of either materiality or breach of fiduciary. At the motion to dismiss stage, a court accepts all factual allegations in a complaint as true and draws all reasonable inferences in the plaintiff's favor. Sec. & Exch. Comm'n v. Cuban, 620 F.3d 551, 553 (5th Cir. 2010). Further, unless the district judge certifies its order for an interlocutory appeal, the order is not appealable until after a final decision has been rendered. *See* 28 U.S.C. §§ 1291, 1292(b).

132. § 240.10b–5. *But see* Tex. Gulf Sulphur Co., 401 F.2d at 848 ("An insider is not, of course, always foreclosed from investing in his own company merely because he may be more familiar with company operations than are outside investors.").

133. *See Yang*, 999 F. Supp. 2d at 1011; *Tex. Gulf Sulphur Co.*, 401 F.2d at 848.

134. It is undisputed that a merger is one of the most important events that can occur for a small company. Sec. & Exch. Comm'n v. Geon Indus., Inc., 531 F.2d 39, 47 (2d Cir. 1976). Thus,

The difficulties incident to applying the probability/magnitude test in this context render it necessary to establish some analytical assumptions up front. In its complaint, the SEC alleges that Panuwat purchased Incyte call options within minutes of receiving an email from Medivation's CEO detailing Pfizer's interest in proceeding with the acquisition.[135] Given Panuwat's involvement with and the circumstances encompassing the potential acquisition of Medivation, this Comment will assume the probability/magnitude inquiry will turn on the magnitude of the acquisition information.[136] And, because the acquisition information is about Medivation alone, the magnitude of the information with respect to Incyte depends on whether and to what degree Medivation and Incyte are "economically linked."[137]

The SEC alleges that the information regarding Pfizer's imminent acquisition of Medivation was material to Panuwat's decision to purchase call options in Incyte.[138] Specifically, the SEC claims that in 2016, there was a market trend of large-cap pharmaceutical companies acquiring mid-cap oncology-focused biopharmaceutical companies with commercial-stage drugs.[139] The SEC alleges that because there were only a few mid-cap biopharmaceutical companies left to acquire at that time—including Medivation and Incyte—information regarding the imminent acquisition of any of the remaining companies made the others

inside information about that merger can be material at an earlier stage even if the probability of it occurring is low at that time. *Id.* at 47–48. However, a survey of applicable case law indicates this application has been limited to the company of which the information directly relates. *See generally O'Hagan*, 521 U.S. at 647–48 (1997) (involving an attorney misappropriating inside information to purchase call options and stock in a company about to be acquired); Sec. & Exch. Comm'n v. Mayhew, 121 F.3d 44, 52 (2d Cir. 1997) (involving an outsider purchasing stocks and options in a company after learning from a corporate insider that the same company was potentially going to be acquired); Sec. & Exch. Comm'n v. Maio, 51 F.3d 623, 637–38 (7th Cir. 1995) (involving tippees breaching their derivative duty by purchasing and selling shares in companies they learned would be acquired); Sec. & Exch. Comm'n v. Michel, 521 F. Supp. 2d 795, 825–36 (N.D. Ill. 2007) (involving an outsider purchasing $1.4 million in stock over six days in a potential acquisition target); Sec. & Exch. Comm'n v. Kornman, 391 F. Supp. 2d 477, 481 (N.D. Tex. 2005) (involving an outsider instructing a trade assistant to purchase stock in a company at a share price below the highest acquisition price mentioned in a prior conversation).

135. Panuwat Compl. ¶ 30, 33.

136. 3 ALAN R. BROMBERG ET AL., BROMBERG & LOWENFELS ON SECURITIES FRAUD § 6:610 (2d ed.). Given the inherent fact-dependent nature of the materiality inquiry, it is impossible to generalize what degree of probability will suffice for materiality. *Id.* Nor is there any defined combination of degrees of magnitude and probability that suffice for purposes of a materiality analysis. *Id.*

137. Any materiality analysis under Rule 10b–5 turns on whether the information "significantly altered the 'total mix' of information made available" in the eyes of a reasonable investor. *Basic*, 485 U.S. at 449. Therefore, if Medivation and Incyte are sufficiently "economically-linked," then nonpublic information pertaining to an imminent acquisition of one may be material to the other.

138. Panuwat Compl. ¶ 31.

139. *Id.* ¶ 22.

more valuable acquisition targets.[140] This information, the SEC argues, *could* positively affect the remaining mid-cap companies' stock prices.[141] Necessarily then, the SEC's theory of shadow trading liability rests primarily on the correlation between the share prices of Medivation and Incyte.[142]

Generally, there are a number of economic drivers that influence a company's share price.[143] Those drivers aside, it is undisputed that a company's correlation to some other asset or asset class could be considered when making an investment decision in that company.[144] Correlation is "a measure of the

---

140. *Id.* The SEC also notes Panuwat was aware that "the previous announcement of the acquisition of a mid-cap oncology-focused company in 2015 by a large-cap pharmaceutical company" resulted in material increases of both Medivation and Incyte stock prices. *Id.*

141. *Id.*

142. Implicit in the SEC's argument is that there exists some relationship of sufficient strength between the share prices of Medivation and Incyte. *See id.* Generally, the strength of the relationship between any two variables can be quantified by computing the correlation or covariance between the variables. Srishti Saha, *Baffled by Covariance vs. Correlation? You're Not Alone.*, BUILTIN (Aug. 25, 2021), https://builtin.com/data-science/covariance-vs-correlation. The difference between the two metrics is straightforward: "correlation measures both the strength and the direction of the [] relationship between two variables" whereas "covariance indicates the direction of the [] relationship." *Id.* Because the SEC is impliedly arguing that a relationship of sufficient strength exists, the author utilized the principles of correlation in the materiality analysis.

143. To understand why the SEC is hedging its theory of insider trading liability on correlation, it is necessary to provide a basic background as to what causes a share price to fluctuate. In the equity market, there are a number of factors that can influence a company's share price. K. Hemadivya & V. Rama Devi, *A Study on Relationship Between Market Price & Earnings Per Share with Reference to Selected Companies*, 2 INT'L J. MKTG., FIN. SERVS. & MGMT. RSCH. (2013). At the most basic level, the forces of supply and demand control. *Id.* If people start buying a security, the share price increases; if people start selling a security, the share price decreases. *Id.* On a deeper level, there are more specific drivers that influence an investor's decision to buy or sell a particular security. Brian Baker, *What Causes a Stock's Price to Go Up or Down?*, BANKRATE (Oct. 28, 2022), https://www.bankrate.com/investing/what-makes-a-stock-go-up-in-price/. These drivers can fall into any of the following categories: (1) economic factors, (2) political news, (3) technical factors, (4) fundamental factors. *Id.* *Economic factors* refer to those macroeconomic metrics—namely, inflation and interest rates—that could impact the future performance of companies in the market, generally. *Id.* For example, if interest rates were to rise drastically, any given company's future cash flows must be further discounted, which pushes its share price lower. *Id.* *Political news* refers to the undisputed fact that legislation and regulations can positively or negatively impact a company's performance. *Id.* *Technical factors* refer to the strategies by short term traders who use any given company's historical performance to predict how the share price will move in the near term. *Id.* These three drivers constantly fluctuate and are very difficult to predict; therefore, their effects on company share prices are generally limited to the short term. *Id.* Consequently, most investors look to the fourth driver—*fundamental factors*—to ascertain any given company's value. *Id.* An investor analyzing the fundamentals of any given company looks to long term factors such as earnings growth, whether the company distributes dividends to its shareholders, and the company's valuation based on industry-specific valuation methods (e.g., Price/Earnings multiple). *Id.*

144. *See, e.g.*, Ting Li, *Intra-Industry Momentum and the Product Market Competition Around the World*, 6 REV. DEV. FIN. 16–25 (2016) (finding that an investment strategy of buying past winners and selling past losers in competitive industries will generate more momentum returns than in less competitive industries); Masha Khoshnoud, *Two Essays on Investors' Attention to*

relationship between two different assets under the same market conditions."[145] Correlation can vary between 1.0 and -1.0, where two assets with a correlation coefficient of (-)1.0 move in "perfect tandem" with one another, and two assets with a correlation coefficient of 0 move in complete polarity with respect to one another.[146] Measuring the correlation between any two assets is relatively simple—any investor with Microsoft Excel can extract the historical returns over any particular investment horizon from a variety of internet sources and compute the correlation between the two asset classes by using Excel's correlation function.[147] Using this methodology, the author calculated the correlation between the average monthly returns of Medivation and Incyte between January 2015 and September 2016 to be 0.4775456.[148] This magnitude indicates there was a *low positive correlation* between Medivation and Incyte during the relevant 2015-2016 time horizon.[149]

While correlation may be considered when investing, using it as an investment strategy is often considered to be "overrated."[150] Correlation is often misleading in the long term because it fails to account for macroeconomic events affecting any given company's share price at different times.[151] Investors typically utilize correlation as a means of determining and mitigating risk.[152] For example, the

---

Economically Linked Firms, ELEC. THESES & DISSERTATIONS, 2004-2019 28 (2017) (finding that a monthly strategy of buying Real Estate Investment Trusts ("REITs") with tenants posting the most positive returns in the prior month, and selling short REITs whose tenants had the most negative returns, yields annual abnormal returns of 5-6% per year).

145. *The Power of Low-Correlation Investing*, ALLIANCEBERNSTEIN 2, http://www.alliancebernstein.com/CmsObjectABD/PDF/InvestorEducation/R25281_LowCorrelation.pdf (last visited Nov. 24, 2021); *see also* Saha *supra* note 142.

146. *The Power of Low-Correlation Investing, supra* note 145.

147. Rick Ferri, *Why Correlation Doesn't Matter Much*, FORBES (Jan. 27, 2014), https://www.forbes.com/sites/rickferri/2014/01/27/why-correlation-doesnt-matter-much/?sh=85c8a3d53544; *Correlation*, EXCEL EASY, https://www.excel-easy.com/examples/correlation.html (last visited Nov. 24, 2021).

148. The daily returns for shares of Medivation and Incyte between January 1, 2015, and September 30, 2016 were abstracted from Investing.com. The primary basis for choosing this time horizon was the SEC's allegations that the nature of the pharmaceutical industry during 2016 was such that large pharmaceutical companies were interested in acquiring mid-cap oncology-focused biopharmaceutical companies with commercial-stage drugs. Panuwat Compl. ¶ 22. After extracting the information, the author then used Excel's correlation function to compute the correlation between the monthly returns of the two companies over the aforementioned time horizon. The correlation analysis is available upon request.

149. Zakaria Jaadi, *Everything You Need to Know About Interpreting Correlations*, TOWARDS DATA SCI. (Oct. 15, 2019), https://towardsdatascience.com/eveything-you-need-to-know-about-interpreting-correlations-2c485841c0b8. Correlation coefficients are interpreted as follows: 0.90 to 1.00 (-0.90 to -1.00) indicates a very high positive (negative) correlation; 0.70 to 0.80 (-0.70 to -0.80) indicates a high positive (negative) correlation; 0.50 to 0.70 (-0.50 to -0.70) indicates a moderate positive (negative) correlation; 0.30 to 0.50 (-0.30 to -0.50) indicates a low positive (negative) correlation; and 0.00 to 0.30 (0.00 to -0.30) indicates negligible correlation). *Id.*

150. Ferri, *supra* note 147.

151. *Id.*

152. *Id.*

investment firm AllianceBernstein employs, *inter alia*, an investment strategy of combining low-correlated asset classes.[153] In other words, AllianceBernstein prefers not to place all of its clients' eggs in one basket. The rationale behind this strategy is that if one asset in the portfolio suddenly loses value, it is less likely the entire portfolio will be significantly impacted because it is composed of assets that do not move in perfect tandem.[154] Given the prevalence of using correlation as an investment strategy to reduce risk and the low positive correlation between Medivation and Incyte, information regarding an imminent acquisition of Medivation by Pfizer is arguably not the type of information a reasonable investor would consider important when deciding whether to invest in Incyte—a competing and separate company. Therefore, the information should be deemed immaterial.[155]

B. Panuwat's Promise

Even if nonpublic information is deemed material, insider trading liability depends on whether Panuwat had a duty to disclose the information or abstain from trading on it altogether.[156] This requirement then presents the question of whether Panuwat owed a fiduciary duty to Medivation or its shareholders.[157] The Supreme Court has provided little guidance on what constitutes a fiduciary relationship under the misappropriation theory.[158] As a result, the SEC promulgated Rule 10b5-2, which provides for three non-exhaustive categories of relationships giving rise to a fiduciary duty to disclose.[159] If a fiduciary

153. *The Power of Low-Correlation Investing*, *supra* note 145.

154. *Id.*

155. It is worth noting that federal courts look to other indicia to determine whether nonpublic information is material. *See, e.g.*, United States v. Mylett, 97 F.3d 663, 667 (2d Cir. 1996) ("[T]he sharp jump in . . . stock price after a formal acquisition announcement was made suffices to support a finding that the event in this case was one of major magnitude."); Sec. & Exch. Comm'n v. Shapiro, 494 F.2d 1301, 1307 (2d Cir. 1974) (looking to behavior of individuals who knew of the merger information as indicia of the information's materiality); *Tex. Gulf Sulphur Co.*, 401 F.2d at 851 (discussing the behavior of the defendants with knowledge of the information as further support for a finding of materiality). However, these factors have not individually served as the sole basis for a finding of materiality, but rather have been referenced as additional circumstances supporting such a finding. Moreover, a finding that the merger information is of insufficient magnitude—and thus, immaterial—is supported by the fact that the very study purporting to document the existence of shadow trading acknowledged that evidence of trading activity in competitors of announcing companies is weak, generally. Mehta, *supra* note 33, at 18.

156. *O'Hagan*, 521 U.S. at 662. The Supreme Court rejected the "parity of information" rule, which imposes "a general duty between all market participants in market transactions to forgo actions based on material, nonpublic information." United States v. McGee, 763 F.3d 304, 311 (3rd Cir. 2014) (quoting *Chiarella*, 445 U.S. at 233).

157. *See McGee*, 763 F.3d at 311.

158. *Id.*

159. *Id.* at 312; 17 C.F.R. § 240.10b5-2(b). The regulation provides that:

> For purposes of this section, a "duty of trust or confidence" exists in the following circumstances, among others:
>
> Whenever a person agrees to maintain information in confidence;

relationship exists, then trading on material, nonpublic information obtained during the scope of the fiduciary relationship constitutes a breach of that duty and thus, is violative of Rule 10b-5.[160]

Assuming, *arguendo*, information regarding Pfizer's imminent acquisition of Medivation to be material to a transaction in Incyte's securities, it appears that Panuwat would face insider trading liability. Because Panuwat is an insider at Medivation—as opposed to Incyte—the classical theory of insider trading liability does not apply.[161] However, as noted above, an outsider could face insider trading liability under the misappropriation theory—a theory of insider trading liability premised on an outsider trading on material, nonpublic information in breach of a fiduciary duty to the source of said information.[162] Here, a fiduciary relationship likely exists because Panuwat signed an employment agreement with Medivation promising, *inter alia*, he would not misappropriate the confidential information he learned during the scope of his employment, except for the benefit of Medivation.[163] By purchasing 578 Incyte call options, which yielded him $107,066 in profit, Panuwat arguably breached his fiduciary duty to Medivation.[164]

IV. THE PANUWAT SNOWBALL

A. The Rule Without Limits

Accepting the SEC's shadow trading theory would likely result in an overinclusive application of Rule 10b-5. According to the SEC, all it takes for material, nonpublic information about one company to be deemed material with

---

> Whenever the person communicating the material nonpublic information and the person to whom it was 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
>
> 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 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.

Id. The constitutionality of this regulation was upheld in *McGee*. *McGee*, 763 F.3d at 316.

160. *O'Hagan*, 521 U.S. at 653; Sec. & Exch. Comm'n v. McGee, 895 F. Supp. 2d 669, 681 (E.D. Pa. 2012).

161. Panuwat Compl. ¶¶ 13–14.

162. *O'Hagan*, 521 U.S. at 659.

163. Panuwat Compl. ¶ 20. *See also* United States v. McPhail, 831 F.3d 1, 5–7 (1st Cir. 2016) (affirming juror finding that a fiduciary duty existed between two individuals under Rule 10b–5 as a result of an email and oral conversations).

164. Panuwat Compl. ¶¶ 33, 38.

respect to different company is that there exists a possibility the information "[could] have a material impact" on that other company.[165] If this is the extent of the inquiry for ascertaining whether information is material with respect to any particular company and because insider trading liability is predicated on the presumption that an individual who is in possession of material, nonpublic information used that information while executing a subsequent transaction,[166] then individuals merely in possession of nonpublic market information about a single company could be legally required to abstain from trading in entire industries. But who is to say it would stop there? If the SEC's theory were to be accepted, individuals with material, nonpublic information about one company could be barred from trading in the securities of companies *outside the industry* so long as the companies are sufficiently economically linked. To some extent, the SEC hinted at such an application.[167] This interpretation would transform Rule 10b-5 into a rule without limits.

The materiality inquiry also poses other concerning legal implications when applied to a shadow trading theory of liability. As noted above, to show that nonpublic information about the imminent acquisition of one company is material with respect to other companies, the SEC must establish that the relative share prices move in tandem to some sufficient degree.[168] When then, is one company's stock price sufficiently correlated to that of another company for an investor to be in danger of facing insider trading liability? Further, given that the materiality inquiry is inherently fact-dependent, applying it to a shadow trading theory of liability would likely lead to inconsistent results. It is undisputed that correlation as a long-term investment strategy is not appealing because it fails to capture the macro and microeconomic events that occur during different time periods.[169] The reverse implication of this investment philosophy is that there are periods where the share price of two companies can be strongly correlated and other periods where the correlation is weak or negligible. Put even more simply, the correlation between the share prices of any two companies can change with time.

---

165. Securities & Exchange Commission's Opposition to Defendant's Motion to Dismiss at 12:24–27, Sec. & Exch. Comm'n v. Panuwat, No. 21-cv-06322-WHO (Aug. 17, 2021).

166. HAZEN, *supra* note 10, at 520.

167. In its brief opposing Panuwat's motion to dismiss, the SEC asserted that "[i]t is uncontroversial that information can be material to more than one company" and that "there is nothing unusual about the fact that information about a transaction, event, or decision made by one particular entity can have a material impact on other companies, especially those in the same industry." SEC Opp'n to Mot. to Dismiss, *supra* note 165, at 12:19–27. This language suggests only that the impact the nonpublic information may have could be more profound with respect to companies in the same industry. The SEC impliedly suggests there is nothing that would preclude material, nonpublic information about one company from also being material with respect to a different company outside the former company's industry.

168. *See* Saha, *supra* note 142.

169. *See* Ferri, *supra* note 147.

Consider a hypothetical industry of four companies: A, B, C, and D. In one year, the share price of Company A is strongly correlated to that of Company B and Company D. Company A Insider obtains information that Company A will be imminently acquired by Company C. Company A Insider buys call options in Company B. When the information of Company A's imminent acquisition goes public, the share prices of Company A, Company B, and Company D increase, and Company A Insider makes a profit. The SEC launches an investigation and files a complaint alleging Company A Insider violated Rule 10b-5; the factfinder agrees. In a subsequent year, the correlation between the share prices of Company B and Company D weakens due to unforeseen economic events—perhaps a global pandemic. Company B Insider obtains nonpublic information that Company B is to be imminently acquired by Company C. Company B Insider buys call options in Company D. When the information of Company B's imminent acquisition goes public, the share price of both Company B and Company D increase, and Company B Insider makes a profit. The SEC launches an investigation, but the factfinder ultimately concludes in this subsequent circumstance that the correlation was not as strong and therefore the information of Company B's imminent acquisition was not material to Company D. Of course, this is merely a hypothetical. But factual circumstances can be changed ever so slightly whereby two insiders in substantially similar circumstances can experience a scatter shot of disparate legal outcomes. This is especially so given that the Supreme Court explicitly rejected the use of a bright-line test of materiality.[170]

B. Increasing Liability Exposure Through Investment Risk Reduction

The Panuwat Snowball also implicates a more general investment strategy: investing in index funds.[171] Take, for example, the S&P 500. "The S&P 500 is a stock index that tracks the share prices of 500 of the largest public companies in the United States."[172] Investors regard it as a proxy for gauging the health of the overall stock market.[173] Because the S&P 500 is weighted by market capitalization (share price multiplied by total outstanding shares), certain companies will hold a heavier weight in the index than others.[174] The inherent diversification in such an index led Wall Street to create a means for an individual to invest in the S&P 500: Exchange-Traded Funds ("ETFs") tracking

---

170. *See Basic*, 485 U.S. at 236.

171. *See* Ari Levy & Lorie Konish, *The Five Biggest Tech Companies Now Make Up 17.5% of the S&P 500 – Here's How to Protect Yourself*, CNBC (Jan. 28, 2020, 4:00 PM), https://www.cnbc.com/2020/01/28/sp-500-dominated-by-apple-microsoft-alphabet-amazon-facebook.html.

172. Kat Tretina & Benjamin Curry, *Investing Basics: How the S&P 500 Works*, FORBES (Dec. 8, 2021, 10:52 PM), https://www.forbes.com/advisor/investing/what-is-sp-500/.

173. *Id.*

174. *Id.*

the S&P 500.[175] Since certain companies bear more weight on the S&P 500, generally their respective performances will impact the value of ETFs tracking the S&P 500.[176]

ETFs are not limited to tracking major indices like the S&P 500—often times they are industry-specific.[177] For example, BlackRock, the world's largest investment management company, created the iShares U.S. Pharmaceuticals ETF, an ETF designed to track the Dow Jones U.S. Select Pharmaceuticals Index, an index tracking the share prices of large U.S. pharmaceutical companies.[178] In industry-specific ETFs such as the iShares U.S. Pharmaceuticals ETF, some component companies hold heavier weights compared to those companies in ETFs tracking larger market indices like the S&P 500.[179] Consequently, the individual performances and activity of the component companies are likely to have an even more profound effect on the industry-specific ETF than would component companies in ETFs tracking

---

175. *See* Levy & Konish, *supra* note 171. An ETF is the product of financial engineering seeking to provide passive investors with a way to "invest" in, *inter alia*, market indices such as the S&P 500:

> An ETF is a basket of securities, shares of which are sold on an exchange. They combine features and potential benefits similar to those of stocks, mutual funds, or bonds. Like individual stocks, ETF shares are traded throughout the day at prices that change based on supply and demand. Like mutual funds shares, ETF shares represent partial ownership of a portfolio that's assembled by professional managers.

Getting to Know Exchange-Traded Funds, MERRILLEDGE, https://www.merrilledge.com/article/getting-to-know-exchange-traded-funds (last visited Nov. 26, 2021). Investing in ETFs provide investors with a number of advantages: tax efficiency, low expenses, flexible trading, the ability to be purchased or sold on margin, no minimum investment, and diversification. *Id.* There are a number of different ETFs that track the S&P 500. *See, e.g.*, E. Napoletano & Benjamin Curry, *Best S&P 500 ETFs Of February 2022*, FORBES (Feb. 7, 2022, 9:11 AM), https://www.forbes.com/advisor/investing/best-sp-500-etfs/.

176. *See* Levy & Konish, *supra* note 171. In 2019, Apple, Microsoft, Alphabet, Amazon, and Facebook accounted for 17.5% of the S&P 500. *Id.* That year, when the share price of Apple and Microsoft soared 86% and 55%, respectively, the value of the S&P also increased 31%. *Id.* Note, however, that ETF managers will not typically track every stock in the S&P 500 and may overweight or underweight certain stocks. *See* Tom Lydon, *Why Equal Weight ETFs Have Been Beating Out the S&P 500*, ETF TRENDS (May 12, 2021), https://www.etftrends.com/etf-education-channel/equal-weight-etfs-beating-s-p-500/ ("Equal weight is one of the oldest alternatives to traditional cap-weighted benchmarks, and the Invesco S&P 500 Equal Weight ETF (RSP) has been one of the lynchpins among equal weight exchange traded funds.").

177. *See Vanguard Sector ETFs*, VANGUARD, https://investor.vanguard.com/etf/sector (last visited Feb. 22, 2022).

178. *See iShares U.S. Pharmaceuticals ETF*, BLACKROCK, https://www.ishares.com/us/products/239519/ishares-us-pharmaceuticals-etf (last visited Feb. 22, 2022).

179. *Compare id.* (finding that Pfizer and Johnson & Johnson combined made up 43.31% of BlackRock's iShares U.S. Pharmaceuticals ETF in February 2022) *with SPDR S&P 500 ETF Trust*, STATE ST. GLOBAL ADVISORS, https://www.ssga.com/us/en/intermediary/etfs/funds/spdr-sp-500-etf-trust-spy (last visited Feb. 22, 2022) (finding that Apple Inc., Microsoft Corp., and Amazon.com, Inc., three of the largest companies in the world, combined made up only 16.56% of the SPDR S&P 500 ETF Trust in February 2022).

broader market indices like the S&P 500. Yet, regardless of whether the ETF tracks a major market index or a specific industry, under the SEC's shadow trading theory of insider trading liability, an insider at one of those component companies holding a heavier weight in an ETF could be legally required to abstain from trading in that ETF simply because he or she has access to material, nonpublic information about his or her company. Similarly, endorsing the SEC's shadow trading theory may also restrict an individual's ability to purchase or sell shares of mutual funds.[180] There are mutual funds that invest exclusively in corporate stocks.[181] Would an individual with material, nonpublic information about one company also be precluded from purchasing or selling shares of a mutual fund holding a significant position in that same company? Is that same individual also precluded from purchasing or selling shares of mutual funds holding significant positions in competitors or business partners of the company in which he or she possesses material, nonpublic information? These questions make clear that the SEC's theory of insider trading liability would not only create needless uncertainty as to what companies are off-limits but also uncertainty as to what types of securities and investment strategies are off-limits.

CONCLUSION

Whether the SEC can impose insider trading liability on Matthew Panuwat will turn on whether it can establish that the information about Medivation's imminent acquisition by Pfizer was material with respect to Incyte. Because the correlation between the share prices of Medivation and Incyte during the relevant time period was low and given the mainstream use of correlation as a hedging strategy, a strong argument can be made that Rule 10b-5's materiality requirement will not be satisfied. If, however, the SEC is successful in applying its novel shadow trading theory of insider liability, then there will be drastic ramifications in the legal and financial landscapes. In the legal realm, the SEC and the Department of Justice would have at their disposal an overinclusive doctrine with no limiting principle. In the market, legitimate ways to invest in market indices and industries would now be scrutinized if, for example, an investor takes a substantial position in a mutual fund with a significant investment in the investor's company. The purpose of Rule 10b-5 is not to eliminate information disparity but to promote the integrity of our capital markets. And, while it goes without saying that Panuwat's transaction is

180. "A mutual fund is a company that pools money from investors," and uses it to create a portfolio of securities. *Mutual Funds*, U.S. SEC. & EXCH. COMM'N, https://www.investor.gov/introduction-investing/investing-basics/investment-products/mutual-funds-and-exchange-traded-1 (last visited Nov. 25, 2021). Like an ETF, investors buy shares in a mutual fund which represent a partial "ownership in the fund and the income it generates." *Id.*

181. For example, Fidelity's Select Health Care Services Portfolio is a mutual fund whereby ten health care companies comprise nearly 75% of its holdings. *Fidelity Select Healthcare Services Portfolio*, FIDELITY (Oct. 31, 2021), https://fundresearch.fidelity.com/mutual-funds/summary/316390665.

arguably suspect, the SEC's attempt, in this case to preserve market integrity via insider trading doctrine is equally so. A shadow trading theory of insider trading liability is a tortured application of Rule 10b-5, stretching its scope too far.