Brooklyn Journal of Corporate, Financial & Commercial Law

Volume 17 | Issue 2 Article 9

5-15-2023

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Kayla Kershen

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Recommended Citation

Kayla Kershen, *SEC v. Panuwat: The Federal Pursuit of Shadow Trading*, 17 Brook. J. Corp. Fin. & Com. L. 151 (2023).

Available at: https://brooklynworks.brooklaw.edu/bjcfcl/vol17/iss2/9

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SEC V. PANUWAT: THE FEDERAL PURSUIT OF SHADOW TRADING

ABSTRACT

In 2021, the SEC filed a complaint against a biopharmaceutical executive, Matthew Panuwat, for trading on material non-public information in violation of both the federal securities laws and his employer's company policies. However, because the subject of the confidential information was not his employer, but a similarly situated peer company, Panuwat's conduct constitutes "shadow trading." The SEC's enforcement, and the Northern District of California's subsequent approval, indicate that company insiders may face liability for shadow trading.

However, as written, the SEC arguably bases its attachment of federal liability on the company policies that Panuwat was bound by and violated. This Note argues that such enforcement of company policies should be avoided by drawing parallels to Van Buren v. United States. Instead, shadow trading should be pursued via misappropriation theory, breaches of company policies should be treated as breaches of contract, and companies should enact effective compliance programs.

INTRODUCTION

On August 17, 2021, the Securities and Exchange Commission (the SEC) filed a landmark complaint against biopharmaceutical executive Matthew Panuwat for conduct coined in recent scholarship as "shadow trading."[1] Insider trading occurs when a company insider uses confidential information—typically called "material non-public information" (MNPI)—about a company issuing securities to trade in that company's securities, while aware that he is breaching a fiduciary duty to the issuing company, its shareholders, or any other source of the MNPI.[2] In contrast, shadow trading

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1. Complaint, S.E.C v. Matthew Panuwat, No. 4:21-cv-06322 (N.D. Cal. Aug. 17, 2021), https://www.sec.gov/litigation/complaints/2021/comp-pr2021-155.pdf [hereinafter Panuwat Complaint]; Mihir N. Mehta, David M. Reeb & Wanli Zhao, *Shadow Trading*, 96 ACCT. REV. (forthcoming July 2021), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3689154.

2. George C. Harris, *Elements of Insider Trading*, *in* INSIDER TRADING LAW AND DEVELOPMENTS 12-13 (Carl H. Loewenson Jr. & Ruti Smithline Eds., 2018). While there is no codified definition of insider trading, this is a commonly accepted construction.

posits that such MNPI can also be relevant for "economically-linked firms,"[3] such that insiders can also profit by trading in the securities of those firms.[4]

Following this framework, Panuwat received MNPI stating that the company he worked for, Medivation, Inc., was being acquired, and he used this information to predict that the stock price of peer company Incyte Corporation would rise in response to the announcement of the acquisition.[5] Based on this, Panuwat purchased hundreds of stock options in Incyte and made over one hundred thousand dollars once the announcement was made public.[6]

Panuwat's actions, and the practice of shadow trading generally, raise important questions such as: Does this attenuated type of informed trading, in which the trader possesses MNPI about a *different* company, constitute a breach of the federal securities laws? Should it? The SEC certainly thinks so. In response to Panuwat's trading, the SEC filed a complaint alleging that "(1) the information he had was material *to Incyte's stock* and (2) he had a duty *to Medivation* to keep it confidential."[7] In establishing the latter duty, the SEC frequently referenced Medivation's confidentiality and insider trading policies.[8] By virtue of his employment and these policies, the SEC argued that Panuwat was duty-bound to keep Medivation's MNPI confidential and to abstain from trading on it.[9] By using Medivation's MNPI to trade in Incyte options, Panuwat breached this duty, despite not transacting in Medivation securities.[10] The SEC determined that this breach "defrauded Medivation and undermined the integrity of, and investor confidence in, the securities markets," thereby violating Section 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934 (the Exchange Act).[11]

SEC v. Panuwat reflects an important departure from previous enforcement actions that has serious implications. As the SEC's first complaint against shadow trading, it implies that liability for insider trading may be expanding. Most notably, the SEC arguably treated Panuwat's breach

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3. The term "economically-linked firms" is not explicitly defined but the article refers to "a company from which private information emerges as a 'source firm' and a stakeholder for which the private information could be price-relevant as a 'linked firm.' In other words, source firms are either business partners or competitors of linked firms."
Mihir N. Mehta, David M. Reeb & Wanli Zhao, *Shadow Trading*, 96 ACCT. REV. (forthcoming July 2021) (manuscript at 1), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3689154. Therefore, "economically-linked firms" could be reasonably understood to be business partners and competitors for which private information may be price-relevant. For further discussion, *see* Part I.

4. *Id.*

5. Panuwat Complaint, *supra* note 1, at 5.

6. *Id.* at 8–9.

7. Matt Levine, *Money Stuff: Insiders Trade in Outside Companies*, BLOOMBERG (Aug. 25, 2021, 12:25 PM), https://www.bloomberg.com/news/newsletters/2021-08-25/money-stuff-insiders-trade-in-outside-companies; Panuwat Complaint, *supra* note 1, at 7–8.

8. Panuwat Complaint, *supra* note 1, at 5.

9. *Id.* at 8.

10. *Id.* at 5–7.

11. *Id.* at 8–9.

of company policy as a violation of federal law. This presents a significant problem: if the SEC were to consistently treat violations of company policies as *per se* insider trading, company policies would have the effect of federal law. The result is an undesirable shift in legislative authority from Congress and the SEC to company boards and committees, which have different goals and incentives. Because these company policies vary greatly, their enforcement would yield unequal results, causing some insiders to face federal consequences for conduct that others do not.

As a solution, this Note suggests that an analogous outcome to *Van Buren v. United States* is appropriate.[12] Just as the Supreme Court in *Van Buren* rejected treating violations of police department policies as violations of the federal Computer Fraud and Abuse Act (CFAA), the SEC and judicial authorities should not treat violations of company insider trading policies as violations of Rule 10b-5 of the Exchange Act.[13] Instead, company insider trading policies should be enforceable as contracts with remedies for breach.[14] Internally, companies can effectively limit instances of shadow trading by enacting effective compliance programs.[15]

Following this Introduction, Part I of this Note will discuss the statutory framework for insider trading, the evolution of insider trading theory, and shadow trading. It will also apply existing theory to shadow trading using *Panuwat* as an example and discuss the Insider Trading Prohibition Act (ITPA) that was recently approved by the House of Representatives. In Part II, this Note will address the importance of company insider trading policies in minimizing and averting risk and liability while discussing trends regarding the disclosure of these policies. Secondly, it will discuss the SEC's proposed amendments to Rule 10b5-1, which would mandate disclosure. Thirdly, Part II will propose and explore a three-part classification of insider trading policies based on their levels of disclosure and the components of these policies. Finally, Part III will explain an analogous Supreme Court case, *Van Buren v. United States*, and suggest that the application of its outcome in the shadow trading context is an appropriate solution. It will also suggest contractual treatment of these policies and effective compliance programs as further solutions.

12. Van Buren v. United States, 141 S. Ct. 1648 (2021).

13. *Id.*

14. Violations of insider trading policies should be treated as breaches of contract, but specific enforcement would be an inappropriate remedy because it would enforce an involuntary employment relationship if one of the parties terminated the relationship. Additionally, specific performance would compromise the ability of corporate principals to choose their agents.

15. *See* Mehta et al., *supra* note 1, at 3.

I. STATUTORY FRAMEWORK AND EVOLUTION OF INSIDER TRADING AND SHADOW TRADING.

A. THE STATUTORY FRAMEWORK AND EVOLUTION OF INSIDER TRADING JURISPRUDENCE

Fundamentally, the prohibition against insider trading originates from Section 10(b) of the Exchange Act and SEC Rule 10b-5 thereunder.[16] Section 10(b) makes it illegal "[t]o use or employ . . . any manipulative or deceptive device or contrivance" in connection with a securities transaction and in violation of the rules put forth by the SEC.[17] To specify what constitutes a "manipulative or deceptive device or contrivance," the SEC promulgated Rule 10b-5.[18] In pertinent part, this regulation states:

> [i]t shall be unlawful for any person, directly or indirectly, by the use of any means . . . [t]o employ any device, scheme, or artifice to defraud . . . or . . . to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.[19]

Notably, these laws neither explicitly prohibit nor codify a definition of insider trading.[20] This was not an unintentional omission; rather, the SEC intended Section 10(b) to act as a "catch-all clause to prevent fraudulent practices."[21] Together, these provisions "'[] assure that dealing in securities is fair and without undue preferences or advantages among investors.'"[22] Thus, the absence of a federal definition subverts the issue of an insufficient definition failing to encompass fraudulent activity in its many potential forms.

Instead, the law of insider trading is judge-made, developed, and evolving through various interpretations of Rule 10b-5.[23] Most importantly, the Supreme Court has endorsed two theoretical approaches under which liability is found: the "special relationship" (often called "traditional" or "classical") and the "misappropriation" theories.[24]

16. 15 U.S.C.A. § 78j(b) (West 2021); 17 C.F.R. § 240.10b-5 (2021); Harris, *supra* note 2, at 11.

17. 15 U.S.C.A. § 78j(b) (West 2021).

18. *Id.*; Harris, *supra* note 2, at 11.

19. 17 C.F.R. § 240.10b-5 (2021).

20. Harris, *supra* note 2, at 11; *see generally* Kayla Quigley, *The Insider Trading Prohibition Act: A Small Step Towards a Codified Insider Trading Law*, 26 FORDHAM J. CORP. & FIN. L. 185 (2020). Whether there should be a codified definition of insider trading is a hotly contested issue and previous attempts have been unsuccessful.

21. Chiarella v. United States, 445 U.S. 222, 226 (1980).

22. *Id.* at 241.

23. Harris, *supra* note 2, at 11.

24. WILLIAM K.S. WANG & MARC I. STEINBERG, INSIDER TRADING § 5.1 (3d ed. 2010); United States v. O'Hagan, 521 U.S. 642, 651–52 (1997).

The Supreme Court first applied Rule 10b-5 to insider trading and established the special relationship theory in the landmark case *Chiarella v. United States*.[25] In this case, Chiarella worked for a financial printer, where he was privy to five non-public announcements of corporate takeover bids.[26] Using and withholding this information, he made $30,000 by promptly acquiring stock in the target companies and selling them after the information was made public.[27] In deciding whether Chiarella's omission violated this provision, the Court explained that liability for fraud based upon nondisclosure must be premised upon a duty to disclose, which "does not arise from mere possession" of MNPI.[28] Instead, this duty to disclose must stem from a special relationship "of trust and confidence between parties to a transaction."[29] Because Chiarella was not an agent or fiduciary in whom the target companies had placed trust, he was under no duty to disclose and therefore had not violated Rule 10b-5.[30]

Three years later, in *Dirks v. SEC*, the Supreme Court reaffirmed the special relationship theory and expanded it to include a personal benefit requirement and liability for tippers and tippees.[31] Justice Powell reasoned that a tippee ordinarily owes no fiduciary duties to a corporation or its shareholders.[32] However, as a derivative of the insider's duty, the tippee may still have a duty to disclose his material information or abstain from trading.[33] If an insider discloses MNPI to a tippee for his own personal benefit, whether that benefit is direct or indirect, that insider has breached his fiduciary duty.[34] Where a tippee "knows or should know that there has been a breach," that tippee assumes the insider's fiduciary duty.[35] Because the Court found that the insiders who tipped Dirks did not receive a personal benefit from doing so, there was no breach by the insiders and, thus, no secondary breach by Dirks in disclosing the information.[36]

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25. WANG & STEINBERG, *supra* note 24, at § 5.2.1.

26. *Chiarella*, 445 U.S. at 224.

27. *Id.*

28. *Id.* at 235 ("When an allegation of fraud is based upon nondisclosure, there can be no fraud absent a duty to speak. We hold that a duty to disclose under § 10(b) does not arise from the mere possession of nonpublic market information.").

29. *Id.* at 230.

30. *Chiarella*, 445 U.S. at 232.

31. Dirks v. S.E.C., 463 U.S. 646, 660, 662 (1983); Carl H. Loewenson, Jr. & Andreea Vasiliu, *A Brief History of Insider Trading Law*, *in* INSIDER TRADING LAW AND DEVELOPMENTS 23, 27 (Carl H. Loewenson Jr. & Ruti Smithline Eds., 2018); WANG & STEINBERG, *supra* note 24, at § 5.2.1.

32. *Dirks*, 463 U.S. at 655.

33. *Id.* at 659.

34. *Id.* at 662.

35. *Id.*

36. *Id.* at 667.

This construction of insider trading leaves a large gap through which insider traders can escape liability.[37] For example, classical theory neglects to reach those in possession of MNPI who trade in company securities without a fiduciary duty to the company and its shareholders.[38] *Chiarella* presents a good example. Chiarella gained unintentional access to MNPI and traded upon it but had no fiduciary relationship with the target companies in which he traded.[39] It may also neglect to reach those in tippee-chains who are far removed from the insider by making it hard to prove that the tippee was aware that the insider benefitted from tipping.[40] In his dissent, Justice Blackmun contested the addition of personal benefit as an element of an insider's breach because of its irrelevance to shareholder injury.[41] He argued that, under the majority's approach, a tippee might escape liability for securities fraud if the insider received no personal benefit for tipping, despite existing shareholder injury.

In *United States v. O'Hagan*, the Supreme Court endorsed the misappropriation theory, thereby filling some of the gaps in classical theory.[42] In this case, O'Hagan was a partner at a law firm that was counseling a company regarding a possible tender offer of Pillsbury Company common stock.[43] While his firm was retained and before the announcement of the offer, O'Hagan purchased thousands of call options and common stock in Pillsbury.[44] Predictably, the price of Pillsbury stock rose dramatically upon the announcement of the offer, at which time O'Hagan sold his stocks and options for a profit of $4.3 million.[45]

Because liability under the classical theory is premised upon a fiduciary relationship between an insider and the company's shareholders, O'Hagan would have escaped liability if it were applied.[46] He had no fiduciary relationship to the shareholders of the company retaining his firm, nor was he tipped by someone in breach of this relationship. Instead, the Supreme Court upheld the validity of the misappropriation theory, under which "a person commits fraud 'in connection with' a securities transaction . . . when he misappropriates confidential information for securities trading purposes, in breach of a duty owed to the source of the information."[47] Despite

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37. WANG & STEINBERG, *supra* note 24, at § 5.4; Loewenson, Jr. & Vasiliu, *supra* note 31, at 29; Dirks v. S.E.C., 463 U.S. at 668–79.

38. Loewenson, Jr. & Vasiliu, *supra* note 31, at 28–29.

39. Chiarella v. United States, 445 U.S. at 224–32 (1980).

40. Quigley, *supra* note 20, at 194. For discussion of tippee liability, *see* United States v. Newman, 773 F.3d 438 (2d Cir. 2014), *abrogated by* Salman v. United States 580 U.S. 39 (2016).

41. *Dirks*, 463 U.S. at 673–74 (Blackmun, J. dissenting).

42. United States v. O'Hagan, 521 U.S. 642, 646–47 (1997); Loewenson, Jr. & Vasiliu, *supra* note 31, at 31.

43. *O'Hagan*, 521 U.S. at 647.

44. *Id.* at 647–48.

45. *Id.* at 648.

46. *See id.* at 652–53; Loewenson, Jr. & Vasiliu, *supra* note 31, at 31.

47. *O'Hagan*, 521 U.S. at 652, 659.

O'Hagan's lack of fiduciary obligation to Pillsbury's shareholders, his conduct breached a fiduciary duty to his law firm and its corporate client under the misappropriation theory.[48]

While the misappropriation theory encompasses more conduct than the classical theory, courts have questioned its validity, arguing that it encompasses too much conduct.[49] Before the Supreme Court's *O'Hagan* decision, the Fourth and Eighth Circuits rejected misappropriation on the grounds that it does not satisfy two requirements of Section 10(b): (1) the requirement of deceit and (2) the requirement of fraud "in connection with the purchase or sale of any security."[50] Specifically, the Fourth Circuit explained that the theory:

> . . . authorizes criminal convictions for simple breaches of fiduciary duty and similar relationships of trust and confidence, whether or not the breaches entail deception within the meaning of section 10(b) and whether or not the parties wronged by the breaches were purchasers or sellers of securities, or otherwise connected with or interested in the purchase or sale of securities.[51]

Essentially, the Fourth Circuit rejected the idea of expanding criminal liability to informed traders who wronged the source of the MNPI when the source may be unrelated to any securities transactions.[52] It also rejected the notion of misappropriation as constituting fraud or deception, reasoning that Section 10(b) is concerned with investor protection and not general source protection.[53]

Misappropriation theory reveals tension regarding investor protection. On the one hand, the Fourth Circuit is right: tying fraud to the source of the MNPI seems more like source protection than investor protection. The Supreme Court has also stated that "not every instance of financial unfairness

48. Loewenson, Jr. & Vasiliu, *supra* note 31, at 33.

49. *See* WANG & STEINBERG, *supra* note 24, § 5.4.1 at 419–20.

50. 15 U.S.C.A § 78j(b) (West 2021). *See* WANG & STEINBERG, *supra* note 24, § 5.4.1 at 419–20; *see generally* Unites States v. Bryan, 58 F.3d 933 (4th Cir. 1995), *rev'd*, 521 U.S. 642 (1997); United States v. O'Hagan, 92 F.3d 612 (8th Cir. 1996).

51. *Bryan*, 58 F.3d at 944*; see also O'Hagan*, 521 U.S. at 642. Justice Ginsburg addressed the arguments against misappropriation theory, contending that it "meets the statutory requirement that there be 'deceptive' conduct 'in connection with' securities transactions." *Id.* at 659. In Ginsburg's view, the deceit requirement is met because "[a] fiduciary who '[pretends] loyalty to the principal while secretly converting the principal's information for personal gain . . . 'dupes' or defrauds the principal." *Id.* at 653–54 (citations omitted). The requirement that the fraud be "in connection with" a securities transaction is also met because "the fiduciary's fraud is consummated . . . when, without disclosure to his principal, he uses the information to purchase or sell securities . . . .This is so even though the person or entity defrauded is not the other party to the trade, but . . . the source of the nonpublic information." *Id.* at 65–66.

52. *Bryan*, 58 F.3d at 944–47.

53. *Id.* at 946–49 ("[B]y its own terms, the misappropriation theory does not even require deception, but rather allows the imposition of liability upon the mere breach of a fiduciary relationship or similar relationship of trust and confidence.").

constitutes fraudulent activity under § 10(b)."[54] However, misappropriation of MNPI by insiders is financially harmful to investors and leads them to trade in a way they may not without the information asymmetry. Investors then take the fall for insiders by transacting with them, regardless of whether the insiders had thereby breached a fiduciary duty to them. Classical theory only proscribes illicit trading with a small population of the overall market of investors, even though they may possess MNPI about different companies or that may affect different companies. Misappropriation theory, however, prohibits a broader range of conduct by tying the duty requirement back to the source and thereby protecting investors from financial harm. An important question, then, is whether the effect of Section 10(b) should be to ensure equal information to investors.[55]

Since the Supreme Court's sponsorship of misappropriation theory in *O'Hagan*, the SEC put forth Rule 10b5-1, which explicitly expands the definition of the "'manipulative and deceptive devices' prohibited by Section 10(b)" to include misappropriation.[56] Even so, the Fourth Circuit's contentions hold weight, especially in the context of shadow trading. Given these considerations, it is not clear that this is a desirable application of misappropriation theory.[57]

B. SHADOW TRADING

In September 2020, Professors Mehir N. Mehta, David M. Reeb, and Wanli Zhao published their forthcoming paper on ssrn.com, detailing their study of conduct they coined "shadow trading."[58] They defined this trading as attempts by corporate insiders to "circumvent insider trading restrictions

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54. Chiarella v. United States, 445 U.S. at 232–34; Bryan, 58 F.3d at 950.

55. *Compare Chiarella*, 445 U.S. at 233–34 ("[N]ot every instance of financial unfairness constitutes fraudulent activity under § 10(b)."), *with Bryan*, 58 F.3d at 950 ("If, as the Supreme Court has held, the fraud-on-the-market theory is insupportable because section 10(b) does not ensure equal information to all investors, *a fortiori* such a general fraud-on-the-source theory in pursuit of the same parity of information cannot be defended.") (paraphrasing *Chiarella*, 446 U.S. at 233–34). Note that the Fourth Circuit seems to mischaracterize the Supreme Court's statement here in a way that may be too broad. While there may be financial unfairness within the market that is not fraudulent, this does not necessarily mean that the fraud-on-the-market theory is insupportable, nor does it mean that the fraud-on-the-market theory implies that all investors have equal information. Regardless, this tension brings important considerations to the surface regarding the goals of the federal securities laws.

56. 17 C.F.R § 240.10b5-1(a) (2021) ("The 'manipulative and deceptive devices' prohibited. . .include, among other things, the purchase or sale of a security of any issuer, on the basis of material nonpublic information about that security or issuer, in breach of a duty of trust or confidence that is owed directly, indirectly, or derivatively, to the issuer of that security or the shareholders of that issuer, or to any other person who is the source of the material nonpublic information.").

57. Defendant's Reply in Support of his Motion to Dismiss at 2, S.E.C. v. Panuwat, No. 4:21-cv-06322-WHO (N.D. Cal. filed Dec. 20, 2021), 2021 WL 7444224, at *3 ("[T]he SEC's reliance on a novel misappropriation theory violates Panuwat's due process rights and seeks to improperly expand the federal securities laws.").

58. *See generally* Mehta et al., *supra* note 1.

by using their private information to facilitate trading in economically linked firms."[59] Essentially, shadow trading occurs when a corporate insider uses MNPI to trade in the securities of "linked firms" for which the MNPI may be "price-relevant"—typically business partners or competitors of the insider's firm, which is called the "source firm."[60] Theoretically, corporate insiders engage in this practice to subvert insider trading restrictions while exploiting their MNPI.[61]

In support of this hypothesis, Mehta, Reeb, and Zhao found that insider trading decreases, and shadow trading increases, after prevalent SEC insider trading actions and in the wake of corporate announcements.[62] In fact, the study estimates that shadow traders profit anywhere from $139,400 to $678,000 from a single transaction.[63]

If shadow trading is as common as the study suggests, there are a few possible reasons why it has not been prosecuted until recently. First, the SEC may have been ignorant of its existence until the 2020 study. Second, shadow trading departs from the typical construction of insider trading whereby an insider receives MNPI about the company he works for and uses it to trade in its stock. In such cases, the elements of fiduciary duty and materiality are clear: the insider owes his employer company a fiduciary duty, and, as the subject of the information, its materiality to the employer company is clear. Where shadow trading is involved, however, these elements are less clear and render it harder to prosecute.

C. SEC v. Panuwat

On August 17, 2021, the SEC filed a complaint against Matthew Panuwat, alleging violations of federal insider trading law for shadow trading conduct.[64] Panuwat was Senior Director of Business Development at Medivation, a midsize biopharmaceutical company, and a former investment banker who "specialized in deals involving the pharmaceutical industry."[65] As part of his employment, Panuwat signed Medivation's insider trading and confidentiality policies, the former of which banned shadow trading.[66] Although Medivation omitted the punchy moniker, its policy asserted that using MNPI "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*** . . . is illegal . . . ."[67]

59. *Id.* at Abstract.
60. *Id.* at 1.
61. *Id.* at 19.
62. *Id.* at 3.
63. *Id.* at 2.
64. *See generally* Panuwat Complaint, *supra* note 1; Mehta et al., *supra* note 1.
65. Panuwat Complaint, *supra* note 1, at 1, 4–5.
66. *Id.* at 5, 7–8.
67. *Id.* at 5.

In 2016, when large pharmaceutical corporations were looking to acquire midsize biopharmaceutical companies, Medivation became a target for acquisition.[68] Panuwat was closely involved in this discussion, and a similarly situated midsize biopharmaceutical company called Incyte was frequently referenced as one of the few comparable peers in the industry by the investment banks advising Medivation.[69] Predictably, Incyte was also likely to become a target for acquisition.[70]

On August 18, 2016, Medivation's Chief Executive Officer sent Panuwat and other executives a confidential email stating that Medivation would be acquired by pharmaceutical giant Pfizer, Inc., with final details to be resolved later that day.[71] Within minutes, Panuwat purchased 578 Incyte call option contracts from his work computer in anticipation of an increase in Incyte's stock price upon the announcement of Medivation's acquisition.[72] On August 20, the merger agreement was signed, and the public announcement was made on August 22.[73] That day, the stock prices of Incyte and similar companies jumped, causing Panuwat to make $107,066 from his Incyte purchase.[74]

The SEC charged Panuwat with violating Rule 10b-5 and, in its complaint, frequently referenced Medivation's insider trading policies as establishing a duty of trust and confidence that Panuwat owed to Medivation.[75] In violating these policies, the SEC concluded that Panuwat "defrauded Medivation and undermined the integrity of, and investor confidence in, the securities markets."[76]

In support of his motion to dismiss, Panuwat argued that the SEC stepped outside the scope of the insider trading laws and its own enforcement authority.[77] In doing so, the SEC allegedly violated his due process rights and threatened to impermissibly expand the federal securities laws by enforcement.[78] Panuwat also argued that the SEC failed to plead that he "(i) traded on material nonpublic information about Incyte, (ii) breached a duty to Medivation, or (iii) acted with scienter."[79]

The Northern District of California denied the motion to dismiss, finding that Section 10(b) and Rule 10b-5 were broad enough to encompass Panuwat's conduct.[80] It held that the standard for materiality, set forth in

68. *See id*. at 5–6.
69. *Id.*
70. *See id.* at 5-9.
71. Panuwat Complaint*, supra* note 1, at 7.
72. *Id.* at 8.
73. *Id.* at 8–9.
74. *Id.* at 9.
75. *Id.* at 7–8.
76. *Id.* at 8.
77. Defendant's Reply in Support of His Motion to Dismiss, *supra* note 57, at 1.
78. *Id.* at 2.
79. *Id.* at 6.
80. S.E.C. v. Panuwat, 2022 WL 633306, at *4 (N.D. Cal. 2022).

Basic Inc. v. Levinson,[81] "does not assign a source to the information at issue" and "only focuses on whether the information is significant 'to the issuer of the securities.'"[82] Therefore, information may be material to more companies than the two engaged in a merger, and Medivation's information about its merger was both confidential and material to Incyte.[83] Since Incyte is a publicly traded company, the Court found it to be subject to Medivation's insider trading policy and held that Panuwat breached his resulting duty by trading in Incyte stock.[84] To establish scienter, the District Court required the SEC to show "actual use," which was established by the temporal proximity of Panuwat's purchase to the email he received about the merger with Pfizer.[85] Finally, the Court dismissed Panuwat's due process concerns by arguing that he "ignore[d] two important checks on liability: materiality and scienter."[86]

This case is a perfect example of shadow trading since the Medivation MNPI held by Panuwat was also relevant for the "economically-linked" firm, Incyte, allowing Panuwat to profit.[87] If the study is correct, and shadow traders reap between $139,400 and $678,000 from a single transaction, then Panuwat's $107,000 profit is minuscule compared to that of other, undetected shadow traders.[88]

Since this case has only survived a motion to dismiss,[89] unanswered questions remain. Does an insider's trade in the securities of an allegedly economically-linked company with whom he is not employed constitute a breach of a duty of trust or confidence to the employer? Second, is an insider trading or like policy sufficient to establish that a duty of trust or confidence has been breached? Third, when is one company's information material to another company? And finally, if this conduct is to be prohibited, how should it be done? The Court has not yet addressed Panuwat's regulation by enforcement argument. It is clear that allegations of shadow trading may be sufficient to plead a Rule 10b-5 claim, but a judgment on the merits is still not guaranteed.

81. Basic Inc. v. Levinson, 485 U.S. 224, 249 (1988).
82. *Panuwat*, 2022 WL 633306, at *5.
83. *Id.*
84. *Id.* at *6.
85. *Id.* at *6–7.
86. *Id.* at *8.
87. Mehta et al., *supra* note 1, at 1.
88. Panuwat Complaint, *supra* note 1, at 9.
89. The Panuwat Complaint survived a motion to dismiss, *see generally* S.E.C. v. Panuwat, 2022 WL 633306 (N.D. Cal. 2022), and a Zoom hearing is scheduled for March 28, 2023. *Securities and Exchange Commission v. Panuwat*, LAW360, https://www.law360.com/cases/611be383a6ec47018a398a8f/dockets?page=1 (last visited Mar. 5, 2023).

D. APPLICATION OF LAW TO *SEC V. PANUWAT*

Predictably, shadow trading does not fit neatly within the classical and misappropriation theories of prohibition. Shadow trading is unenforceable as fraud under classical theory because of the requirement of a fiduciary duty to the shareholders of the companies the insider is trading in. Panuwat, for example, owed a duty to Medivation and its shareholders as an employee. However, he did not owe a duty to Incyte shareholders; like Chiarella, he was neither an agent, a fiduciary, nor someone the company entrusted. In fact, *Chiarella* holds that "a duty to disclose under § 10(b) does not arise from mere possession of nonpublic market information."[90] Therefore, *Chiarella* and the special relationship theory suggest that Panuwat's activity is legal under federal law.

The application of misappropriation theory is ambiguous and reflects key issues in pursuing shadow trading. The authors of the 2020 study assert that the issue is the "lack of a clear breach of fiduciary responsibility."[91] However, this breach of fiduciary duty arguably follows the standard set forth in *O'Hagan* because Panuwat misappropriated Medivation's MNPI to trade. The "deceptive device"[92] was Panuwat's act of "feigning fidelity" to Medivation, the source of the information, while secretly using the company's information for personal gain.[93] In its complaint, the SEC's wording of this conclusion parallels that of *O'Hagan.*[94]

On the other hand, Justice Ginsburg also said in the *O'Hagan* majority opinion that the misappropriation of information by a fiduciary of the source "in breach of a duty of loyalty and confidentiality, defrauds the principal of the exclusive use of that information."[95] Notably, the complaint neglects to mention Panuwat tipping or otherwise exposing the news of the acquisition, thus bringing breach of confidentiality into question. Similarly, it is unclear that he breached a duty of loyalty without transacting in Medivation stock. However, he could be seen as having stolen company information and certainly engaged in self-dealing. The element of exclusive use is also unclear; Panuwat arguably did not deprive Medivation of the exclusive right to use or announce this information without disclosure.

However, the SEC's use of misappropriation theory shows that it is workable in the shadow trading context. Assume that Justice Ginsburg's

90. *Chiarella*, 445 U.S. at 235.
91. Mehta et al., *supra* note 1, at 1.
92. 15 U.S.C.A § 78j(b) (2021).
93. *O'Hagan*, 521 U.S. at 655.
94. *Compare* Panuwat Complaint, *supra* note 1, at 8 ("Panuwat's undisclosed, self-serving use of Medivation's information to purchase securities, in breach of his duty of trust and confidence, defrauded Medivation and undermined the integrity of, and investor confidence in, the securities markets."), *with O'Hagan*, 521 U.S. at 652 ("Under this theory, a fiduciary's undisclosed, self-serving use of a principal's information to purchase or sell securities, in breach of a duty of loyalty and confidentiality, defrauds the principal of the exclusive use of that information.").
95. *Id.* at 652.

statement that the illicit trade "defrauds the principal of the exclusive use of that information" is a possible consequence instead of an essential element of the theory. Further, assume that the insider still defrauds the principal by pretending to be loyal while secretly trading. The relevant question then shifts from whether there is a fiduciary duty and a resulting breach to whether the insider *used* the company's information,[96] pursuant to the standard of scienter used by the Northern District of California.[97] This is a viable solution to the haziness of fiduciary duty because the element of deception remains along with flexibility to account for other forms of deception.

Establishing use, and therefore scienter, in the shadow trading context is also generally problematic. The temporal proximity between Panuwat's receipt of the confidential email and his purchase of Incyte options makes the inference that he used this information to trade more intuitive. Nonetheless, use becomes less clear when the information in question is mixed with public knowledge about the market to form deductions. This makes it hard for a fact finder to determine the prevalence of the relevant piece. Absent the news of the merger, Incyte's desirability as a target for acquisition may still have induced a reasonable buyer to conclude that its stock price was likely to rise. Panuwat may not be so different from such a buyer. If his trade did not occur so close to the announcement of the acquisition, scienter would have been harder to establish. However, closeness in time to the receipt of MNPI and a major announcement seems to be a good place for judicial authorities to start in addressing use.

Shadow trading also raises a materiality problem that feeds into scienter. This practice and the *Panuwat* example raise the question of whether information about Company A is material to Company B. In previous examples, insiders transacted in the securities of the *subject* of the MNPI, which made it easy to determine that such MNPI was used for trading. Here, however, Incyte was not the subject of the MNPI. This reveals two things: (1) materiality is relative, and (2) information can be material to non-subjects.

The SEC seemed to rely on the definition of materiality endorsed by the Supreme Court in *Basic, Inc. v. Levinson*.[98] On behalf of the majority, Justice Blackmun explained that information is material if there is "a substantial likelihood that the disclosure of the omitted fact would have been viewed by

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96. *See* 17 C.F.R. § 240.10b5-1(b) (2000) (". . .a purchase or sale of a security of an issuer is 'on the basis of' material nonpublic information about that security or issuer if the person making the purchase or sale was aware of the material nonpublic information when the person made the purchase or sale."). There is an "awareness/use" debate in the context of "mixed motives trading," whereby traders act based on confidential information and another reason. This debate may become relevant in the shadow trading context. *See* Andrew Verstein, *Mixed Motives Insider Trading*, 106 IOWA L. REV. 1253 (2021).

97. S.E.C. v. Panuwat, 2022 WL 633306, at *6–7 (N.D. Cal. 2022).

98. Michael A. Asaro, Peter I. Altman & Brian T. Daly, AKIN GUMP STRAUSS HAUER & FELD LLP, *New Shadow Trading Enforcement Lessons for Private Funds*, Aug. 27, 2021, LEXIS; Basic Inc. v. Levinson, 485 U.S. 224 (1988); Panuwat Complaint, *supra* note 1, at 7.

the reasonable investor as having significantly altered the 'total mix' of information made available."[99] In applying this standard, the SEC and the Northern District of California concluded that the news of Medivation's acquisition was also material to Incyte.[100]

Courts have also considered other factors in determining materiality. For example, the Supreme Court in *Basic* noted that trading and profiting could point to materiality.[101] The market effect when the information is made public is also significant.[102] Both of these factors support the conclusion that Medivation's acquisition was material for Incyte. Moreover, a finding of materiality would likely lead to the presumption that the information was used for trading, thereby establishing scienter.

Despite this sound guidance, shadow trading and the relative materiality of information that follows imply that there is an unending chain of economically-linked companies. The term "economically-linked" itself is broad, and companies may face issues in defining it. For example, Medivation's insider trading policy encompassed "the securities of another publicly traded company, including all significant collaborators, customers, partners, suppliers, or competitors of the Company."[103] Upon first glance, this seems like a very specific and all-encompassing list. However, it, too is broad. It is unclear which companies fall under these categories, making it hard for insiders to know whether trading in a specific company is banned. Alternatively, a list that is too specific may be too sensitive to distribute to insiders. Specific lists may also unintentionally provide loopholes to insiders if it fails to encompass all relevant companies. In this way, shadow trading may also greatly expand company liability for failing to properly mitigate these trades and insider liability for trading.

E. THE ROLE OF MEDIVATION'S INSIDER TRADING POLICY IN THE SEC'S COMPLAINT

Perhaps the most noteworthy, yet puzzling, piece of the *Panuwat* complaint is the SEC's frequent references to Medivation's insider trading policy. One provision of the complaint is especially relevant: "[b]y virtue of his employment at Medivation, as well as the confidentiality and insider trading policies that he signed, Panuwat owed Medivation a duty to keep this

99. *Basic Inc.,* 485 U.S. at 231–32 (quoting TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976)).

100. Panuwat Complaint, *supra* note 1, at 7 ("Medivation's undisclosed acquisition would have been viewed by a reasonable investor in Medivation or Incyte as having significantly altered the total mix of information made available."); S.E.C. v. Panuwat, 2022 WL 633306, at *5 (N.D. Cal. 2022).

101. *Basic Inc.,* 485 U.S. at 240 n. 18.

102. *See, e.g.,* United States v. Carpenter, 484 U.S. 19, 28 (1987) ("Had the column not been made available to Journal customers, there would have been no effect on stock prices and no likelihood of profiting from the information leaked by Winans.").

103. Panuwat Complaint, *supra* note 1, at 5.

material nonpublic information confidential, and to refrain from trading on Medivation's confidential information."[104] It is unclear whether Panwat would have had a duty to refrain from shadow trading without these policies.

Absent Medivation's insider trading policy, Panuwat remained a fiduciary of Medivation and its shareholders. As a fiduciary, Panuwat owed the Medivation the duties of loyalty and confidentiality, among others. The duty of loyalty posits that a fiduciary may not place himself in a position where the interests of another conflict with that of his principal—the company and its shareholders.[105] Additionally, a fiduciary may not profit from his position without the knowledge and authorization of the principal, regardless of whether an injury was suffered as a result.[106] Thus, self-dealing is prohibited. Under the duty of confidentiality, fiduciaries may only use or divulge their principals' confidential information only to benefit the principal.[107]

While these duties may be modified contractually and structurally, they are generally done to increase the duties fiduciaries owe to corporations and their shareholders.[108] This is evident in corporate compliance programs, which often prescribe procedures and stricter prohibitions for fiduciaries to follow when trading in securities. Medivation's policies are examples of this. However, this Note argues that these corporate modifications, intended to further define the duties owed by fiduciaries, and acknowledged by them, should not constitute expansions of actionable conduct under federal law.

The *Panuwat* complaint suggests that the SEC thinks otherwise. By its language and frequent references to Medivation's policies, the SEC implies that these policies established and expanded the fiduciary duties Panuwat owed, the breach of which was a Rule 10b-5 violation. However, these policies may have been unnecessary for pursuing this case. Arguably, the SEC's use of misappropriation theory and *Basic Inc.*'s notion of materiality sufficiently stated a claim for Rule 10b-5 fraud: Panuwat engaged in self-dealing and deception by secretly misappropriating Medivation MNPI to trade, thereby breaching his fiduciary duties, and his use of this information is supported by its materiality to Incyte and the timing of his trade. The SEC, therefore, had a recourse to pursue this case without resorting to using Medivation's company policies as a basis for Panuwat's federal violations.

104. *Id.* at 7–8.
105. Martin Day, *Fiduciary Duties*, 15 TRUSTS & TRUSTEES 447, 449–51 (2009); Victor Brudney, *Contract and Fiduciary Duty in Corporate Law*, 38 BOSTON COLL. L. REV. 595, 629–35 (1997).
106. *Id.* at 629–35; Day, *supra* note 105, at 449–51.
107. *Id.*; Brudney, *supra* note 89, at 629–35.
108. *Id.*; *see e.g.,* DEL. GEN CORP. L. § 102(b)(7) (1986).

F. THE INSIDER TRADING PROHIBITION ACT AND ITS EFFECT ON SHADOW TRADING

Importantly, Congress has not codified a federal definition of, or specific legislation against, insider trading.[109] This has not been for lack of trying; Congress has attempted many times to pass a uniform insider trading statute.[110] Each time, these bills were successfully "opposed by the SEC on the ground that they were too narrow or created loopholes through which insider traders could escape."[111] The latest bill, passed by a sweeping majority of the House of Representatives in December of 2019, is called the Insider Trading Prohibition Act (the ITPA or the Act).[112]

The ITPA would codify SEC usage of insider trading and other policies to establish federal liability.[113] Essentially, the ITPA makes it illegal to trade in securities while in possession of MNPI "if such person knows, or recklessly disregards, that such information has been obtained *wrongfully*, or that such purchase or sale would constitute a *wrongful use* of such information."[114] This shift from fraud to wrongfulness is a noteworthy departure from current insider trading jurisprudence, as is its definition.[115] Wrongful trading includes information "obtained by," or the "use [of which] would constitute":

> (C) conversion, misappropriation, or other unauthorized and deceptive taking of such information; or (D) a breach of any fiduciary duty, . . . confidentiality agreement, . . . contract, . . . code of conduct or ethics policy, or a breach of any other personal or other relationship of trust and confidence for a direct or indirect personal benefit.[116]

Thus, the ITPA, in some ways, incorporates misappropriation theory while also making trade in violation of governance policies illegal.

Panuwat's conduct would likely have been illegal under one or both provisions above. He arguably misappropriated Medivation MNPI, and it was unauthorized and deceptive. He clearly breached the insider trading policy, which is often part of corporate codes of conduct or ethics.[117] Lastly,

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109. *See* Jed S. Rakoff, *A Statutory Solution to Insider Trading?*, 27 SEC. LITIG. 2 (2017); Quigley, *supra* note 20, at 187.

110. *See id.* at 186; Rakoff, *supra* note 109.

111. Rakoff, *supra* note 109, at 3.

112. *See* Mark D. Cahn et al., *Insider Trading Prohibition Act Passed by the House of Representatives*, WILMERHALE (Dec. 12, 2019), https://www.wilmerhale.com/en/insights/client-alerts/20191212-insider-trading-prohibition-act-passed-by-the-house-of-representatives; https://www.congress.gov/bill/117th-congress/house-bill/2655/text.

113. Insider Trading Prohibition Act, H.R. 2655, 117th Cong. § 16A (in the Senate, May 19, 2021), https://www.congress.gov/117/bills/hr2655/BILLS-117hr2655rfs.pdf.

114. *Id.*; Quigley, *supra* note 20, at 191–92; Mark D. Cahn et al, *supra* note 112.

115. Quigley, *supra* note 20, at 191–92.

116. Insider Trading Prohibition Act, *supra* note 113, at (c)(1)(D); Quigley, *supra* note 20, at 192.

117. See Part III of this Note for further discussion of corporate insider trading policies.

he violated his employment relationship, by virtue of these policies, for personal gain.

However, the ITPA's federal enforcement of such governance policies is problematic. These policies are enacted by corporate committees and boards of directors in compliance with federal law and otherwise vary. Further, some companies have fewer policies in place, while others have more. Such tailoring among companies, which policies they adopt, and the content and disclosure of those policies may be necessary for companies to best meet their goals.[118] In the absence of a uniform legislative standard, enforcement of these myriad policies will reap varied outcomes. These outcomes may incentivize companies to adopt or omit such optional rules and policies as a means of escaping liability or public scrutiny. Thus, this law would ultimately shift legislative authority from Congress and other administrative agencies to corporate committees and boards.

II. CORPORATE INSIDER TRADING POLICIES: INCENTIVES, EFFICACY AND FUNCTION, DISCLOSURE, AND A PROPOSED CLASSIFICATION.

A. INCENTIVES FOR CORPORATIONS TO ADOPT INSIDER TRADING POLICIES

Unsurprisingly, the threat of liability imposed upon corporations for the actions of their agents is an incentive to adopt stringent insider trading policies. This possible liability looms heavily in the context of the Insider Trading and Securities Fraud Enforcement Act of 1988 (ITSFEA), which authorizes the SEC to impose a civil monetary penalty upon a "controlling person" of "three times the amount of the profit gained or loss avoided as a result of such controlled person's violation."[119] It also requires brokers, dealers, and investment advisors to "establish, maintain or enforce" written policies and procedures to prevent misuse of MNPI.[120] Liability of these controlling persons is contingent upon failure to comply with this requirement or if they "knew or recklessly disregarded" the likelihood of the violation and "failed to take appropriate steps to prevent" the conduct.[121] Thus, while this statute does not explicitly establish an "affirmative duty" of public corporations to enact compliance programs, the fact that they may constitute controlling persons extends ITSFEA's liability to negligent non-

118. *But see* Daniel A. Nathan, *Compliance Programs: How to Prevent Insider Trading Violations*, *in* INSIDER TRADING LAW AND DEVELOPMENTS 173, 174 (Carl H. Loewenson Jr. & Ruti Smithline Eds., 2018) ("Although an insider trading compliance program should be tailored to the company's size, structure, and business and the type of material non-public information that the company might produce or possess, certain common elements are recommended for any such program."). For a discussion of these elements, see Part II of this Note.

119. 15 U.S.C.A. § 78u-1(a)(3).

120. 15 U.S.C.A. § 78o(g); 15 U.S.C.A § 80b-4a.

121. 15 U.S.C.A § 78u-1(b).

brokers, dealers, and investment advisors.[122] As such, the ITSFEA may insulate corporations from liability if they have done their part to implement and enforce an effective policy.[123]

Outside the ITSFEA, the SEC has wide latitude to deter and punish insider trading. As we see in *Panuwat*, it can issue injunctions, civil monetary penalties, and can bar an individual from serving as an officer or director of any and all publicly-held companies.[124] Another common and widely endorsed remedy is to order an accounting and disgorgement of illicit profits.[125] To aid in the detection of violations, the SEC may also encourage individuals to offer information regarding insider misconduct by awarding them "bounties" of up to ten percent of the penalty.[126] Lastly, the SEC may "seek, and any Federal court may grant, any equitable relief that may be appropriate or necessary for the benefit of investors."[127] The SEC thus has various enforcement tools available to wield at its discretion to protect investors and promote fair dealing.[128]

Additionally, reputational harm is an incentivizing threat to corporations. From a shareholder perspective, insider trading may compromise investor confidence in the invested company and in the market itself.[129] Such self-

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122. WANG & STEINBERG, *supra* note 24, at § 13.6.1.

123. *See also id.* Corporations may also be incentivized to adopt insider trading policies because effective compliance policies can mitigate the severity of a criminal sentence. *Id.* Factors considered in determining the sufficiency of such a program include "effective training, monitoring, and enforcement, as well as the designation of a high-level person with overall responsibility for compliance." *Id.*

124. Panuwat Complaint, *supra* note 1, at 10; WANG & STEINBERG, *supra* note 24, at § 7.3, § 7.3.4. Under the Securities Enforcement Remedies and Penny Stock Reform Act of 1990, the SEC can seek from the federal district court to prohibit an individual from serving as an officer or director. *Id.* at § 7.3.4. In terms of severity, the court has the discretion to determine whether the ban is conditional or unconditional and permanent or temporary. *Id.* This remedy is only available if the individual violated the antifraud provisions and has shown that he is unfit to retain such a position. *Id.*

125. WANG & STEINBERG, *supra* note 24, at § 7.3.2. Both the Sarbanes-Oxley Act of 2002 and the Private Securities Litigation Reform Act seem to implicitly support disgorgement as a remedy. However, the SEC chose to disgorge illicit profits "almost as a matter of course" before the enactment of both statutes.

126. *Id.* at § 7.3.3.

127. 15 U.S.C.A. 78u(d)(5).

128. *See also* WANG & STEINBERG, *supra* note 24, at § 7.2.1. Although the scope of this Note addresses SEC action against insider trading, violations of the federal securities laws can also be prosecuted criminally. *Id.* Available punishments include monetary fines and imprisonment, the severity of which is determined by the severity of the crime and prior criminal acts in accordance with the United States Sentencing Guidelines. *Id. See* Daniel A. Nathan, *Insider Trading Enforcement*, *in* INSIDER TRADING LAW AND DEVELOPMENTS 39, 52 (Carl H. Loewenson Jr. & Ruti Smithline Eds., 2018). Moreover, self-regulatory organizations (SROs) such as the New York Stock Exchange (NYSE), the National Association of Securities Dealers Automated Quotations (NASDAQ), and the Financial Industry Regulatory Authority (FINRA) are empowered to investigate and discipline the entities and individuals under their regulatory power. *Id.*

129. WANG & STEINBERG, *supra* note 24, at § 2.3.1. Regarding the theory of investor confidence, a survey of public opinions of insider trading offered "limited support . . . but arguably not sufficient support to validate market confidence as the principal basis for the current insider trading regime."

dealing communicates the message that personal profit reigns supreme to the detriment of shareholder interests. It may also disincentivize individuals from investing by causing them to "feel that the odds are stacked against them" by virtue of their disadvantaged position.[130] Diminished investor confidence may inevitably impede corporate efforts to raise capital.[131] While this projected view of investor perceptions of insider trading has been challenged, the possibility of reputational harm may still induce companies to adopt policies as a preventative measure.[132]

Lastly, such reputational harm may extend to corporate perceptions. If a corporation is associated with insider trading, it may lose potential business transactions with other companies that would involve the handling of MNPI.[133] Transacting companies may even incur joint and several liabilities for the misconduct of their affiliate.[134] Therefore, insider trading may cause corporations to forfeit profitable business opportunities.[135]

B. FUNCTION AND EFFICACY

Insider trading policies are a subset of corporate governance documents, which are not part of corporations' charters or bylaws. Because scholarship has focused almost entirely on charters and bylaws, a result of their central role in corporate formation and organization, non-charter and non-bylaw documents have garnered little academic attention.[136] It is presumably this

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John P. Anderson, Jeremy L. Kidd & George A. Mocsary, *Public Perceptions of Insider Trading*, 51 SETON HALL L. REV. 1035, 1118 (2021).

130. WANG & STEINBERG, *supra* note 24, at § 2.3.1.

131. *Id.*

132. *See, e.g.,* Anderson et al., *supra* note 129. According to empirical data from a national survey of public attitudes toward insider trading, the public does not display the harsh viewpoint that is commonly suggested. While 80% of those surveyed report believing that insider trading is "common or very common," only 66% report believing it should be illegal, and 45% indicated that they "would trade on a tip." *Id.* at 1075. Moreover, less than half of the participants said that they would be less likely to trade in the securities of a company they believed was trading on MNPI, and even less reported that "common" market-wide insider trading would dissuade them from trading. *Id.* at 1082. While this study is a valuable contribution to insider trading academia, these results may not offset an incentivizing effect garnered by the 48.2% of respondents who reported being less likely to trade and the 43.3% who would abstain. *Id.* at 1082–83.

133. Nathan, *Compliance Programs: How to Prevent Insider Trading Violations*, *supra* note 118, at 173.

134. *See* 15 U.S.C.A § 78t(a). "Every person who, directly or indirectly, controls any person liable under any provision of this chapter or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable . . . unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action."

135. Mehta et al., *supra* note 1, at 4.

136. Yaron Nili & Cathy Hwang, *Shadow Governance*, 108 CAL. L. REV. 1097, 1099, 1106 (2020), https://doi.org/10.15779/Z385D8NF8J.

lack of attention that led them to be dubbed "shadow governance documents" in recent scholarship.[137]

From a functional standpoint, shadow governance documents represent an important mechanism for regulating corporate conduct; they "set board procedures and the boundaries of acceptable behavior, and are used as cure-alls for corporate goals."[138] Unlike charters and bylaws, these governance documents tend to provide more specific directives and information and are easily amended.[139] Further, modification of these policies is at the sole discretion of management and therefore does not require shareholder consent.[140]

Importantly, evidence shows that these policies are generally effective and taken seriously. In an interview with a public company director, these policies were described as "a war plan and a commitment to stakeholders that this is what we're doing, that we take our jobs seriously enough."[141] Specifically, they influence the board substantively and procedurally by issuing guidelines for conduct and dispute resolution, setting the annual board calendar, and establishing a record of compliance with federal law.[142]

Evidence also shows that firm-mandated insider trading prohibitions are effective.[143] Corporations with effective insider trading policies report significantly higher incidences of shadow trading compared to when they prohibit shadow trading.[144] This indicates that high quality corporate governance effectively reduces instances of insider trading, so insiders shadow trade instead.[145] Studies corroborate this implication, showing that "corporate self regulation has a significant effect on the rate and profitability of insider trading and improves liquidity in the market for the firm's shares."[146] Conversely, poor corporate governance results in "lower market values because poorly protected shareholder rights result in smaller cash flows to shareholders."[147] Therefore, corporations may have strong

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137. *Id.* at 1099. Specifically, "a shadow governance document is any non-charter, non-bylaw document that speaks to issues of corporate governance. This definition intentionally casts a wide net." *Id.* at 1105.

138. Nili & Hwang, *supra* note 136, at 1105.

139. *Id.* at 1123–24.

140. *Id.* at 1104.

141. *Id.* at 1123.

142. *Id.* at 1123–24.

143. Mehta et al., *supra* note 1, at 4.

144. *Id.* at 4, 19.

145. Mehta et al., *supra* note 1, at 19.

146. J.C. Bettis et al., *Corporate Policies Restricting Trading by Insiders*, 57 J. FIN. ECON. 191, 193 (2000); *see also* Kee H. Chung, John Elder & Jang-Chul Kim, *Corporate Governance and Liquidity*, 45 J. FIN. & QUANTITATIVE ANALYSIS 265, 286 (2010) ("Our empirical results show that companies with better corporate governance generally have greater stock market liquidity as measured by narrower quoted and effective spreads, higher market quality index, smaller price impact of trades, and lower probability of information-based trading [].") (alteration in original).

147. *See id*. at 287. However, this study also explains that it is unknown whether companies adopt high governance standards, and this choice may be made by controlling shareholders. *Id.*

incentives to adopt high quality insider trading policies since they benefit corporations and their shareholders alike.

C. DISCLOSURE

Among the various types of governance documents, disclosure varies by the type of policy and the corporation.[148] With over 90% disclosure of S&P 1500 companies, the most commonly available documents are audit, compensation, and nominating/governance committee charters.[149] Ranking second, 87.1% of companies publicly disclose their corporate governance guidelines.[150] Thirdly, 86.6% of companies offer a code of conduct.[151] It is unsurprising that these documents are the most widely disclosed: they are required by law and/or by self-regulatory organizations (SROs) such as the New York Stock Exchange (NYSE) and the National Association of Securities Dealers Automated Quotations (NASDAQ).[152] Absent these requirements, other policies are disclosed at a significantly lower rate.[153]

In a study published in 2020, insider trading policies were specifically reported to be disclosed by only 12.6% of S&P 1500 companies.[154] While this is low, a study published in 2000 indicated that out of 626 respondent firms, 92% reported having company policies that restrict and/or regulate insider trading.[155] Therefore, it is likely that this nondisclosure is not indicative of an absence of insider trading regulation; instead, these companies likely have policies that the public is simply not privy to.[156]

Given the lack of formal requirements for companies to file insider trading policies with the SEC, it is unsurprising that many are not

148. *See* Nili & Hwang, *supra* note 136, at 1110–15.

149. *Id.* at 1110. Both NYSE and NASDAQ require their listed companies to form and disclose audit, compensation, and nominating/governance committee charters. *Id.* Further, the SEC's Regulation S-K requires that audit committee charters be disclosed on the company's website or proxy statements. *Id.* at 1111.

150. *Id.* at 1112. The NYSE, and not NASDAQ, requires its companies to adopt corporate governance guidelines. *Id.*at 1112–13. High rates of disclosure may be due to "the fact that these guidelines are often integrated with charters and bylaws." *Id.* at 1113.

151. *Id.* at 1114. Codes of conduct are also commonly called an "ethics policy" or a "code of ethics." Section 406 of the Sarbanes-Oxley Act of 2002 requires companies to disclose whether they have adopted such a code and, if not, to explain why. Further, both the NYSE and NASDAQ require companies to adopt and publicly disclose a code of conduct.

152. *See* Nili & Hwang, *supra* note 136, at 1110–15.

153. *Id.* at 1116. For example, human rights and environmental policies are disclosed by 19.8% of companies, political participation policies by 13.7%, and anti-corruption policies by 12.6% of companies.

154. *Id.* at 1117.

155. Bettis et al., *supra* note 146, at 197. It is worth noting that this study was comprised of a survey answered by firms and this statistic regarding the level of corporate adoption of insider trading policies. Thus, these statistics were based upon surveyed answers and not the collection of firm policies.

156. Nili & Hwang, *supra* note 136, at 1121.

disclosed.[157] Despite the federal legal and SRO disclosure mandates of *other* corporate governance documents, some corporations still choose not to comply.[158] However, scholarship indicates that larger companies tend to disclose more of these governance documents.[159]

While shareholders are afforded "no formal powers" in the context of governance documents, disclosure appears to offer shareholders some informal power.[160] This is evidenced in the finding that boards typically have the power to unilaterally alter their governance documents, but choose not to, *especially* when they are disclosed.[161] Modifications to disclosed documents may yield controversial public reactions, and board members attempt to avoid backlash.[162]

Corporations are also incentivized to disclose by proxy advisors such as Institutional Shareholder Services (ISS) and Glass Lewis & Co., which inform shareholders about corporate governance.[163] These advisors issue an Environmental, Social, and Governance Quality Score that is based solely on publicly disclosed policies.[164] As such, corporations gain potential new investors by virtue of public disclosure of ethical policies.

D. THE SEC'S PROPOSED UPDATES TO INSIDER TRADING DISCLOSURE

On December 15, 2021, the SEC proposed amendments to Rule 10b5-1 of the Exchange Act, which provides an affirmative defense against allegations of insider trading if the trade was made pursuant to a trading plan or contract enacted before the trader obtained MNPI.[165] Regarding the disclosure update, the proposed revision would require companies registered with the SEC to disclose whether they have adopted, terminated, or modified a securities trading "contract, instruction or written plan," as well as the contents of that plan.[166] Companies that have not adopted such policies and procedures are required to explain why.[167] Aside from these requirements,

157. Alan D. Jagolinzer et al., *Corporate Governance and the Information Content of Insider Trades*, 49 J. ACCT. RSCH. 1249, 1253 (2011).

158. Nili & Hwang, *supra* note 136, at 1111.

159. *Id.* at 1118.

160. *See id.* at 1124–25.

161. *Id.*

162. *Id.* at 1125.

163. Nili & Hwang, *supra* note 136, at 1127–28.

164. *Id.* at 1128.

165. 17 C.F.R. § 240.10b5-1 (2000); *see also* Kendra Wharton, *United States: SEC Proposes Updates to Insider Trading Disclosure and Affirmative Defense Requirements*, CADWALATER, WICKERSHAM, & TAFT LLP (Dec. 21, 2021), https://www.mondaq.com/unitedstates/securities/1143412/sec-proposes-updates-to-insider-trading-disclosure-and-affirmative-defense-requirements.

166. Rule 10b5-1 and Insider Trading, Exchange Act Release No. 33-11013, 34-93782, File No. S7-20-21 (proposed Dec. 15, 2021) [hereinafter SEC Exchange Act Release].

167. *Id.*

companies have the discretion to determine which policies and procedures to implement.[168] This disclosure is intended to deter abuses of the affirmative defense under Rule 10b5-1 and to allow investors and the SEC to determine whether these plans effectively mitigate misuse of MNPI.[169]

Given the SEC's enforcement powers, such disclosure mandates may cause companies to comply. Disclosure inevitably causes companies to be held accountable for the quality of their corporate governance, which may lead to better governance, higher investor confidence, and improved liquidity for companies' shares. Alternatively, it may be restrictive because companies may be less likely to amend their policies when necessary to avoid investor backlash.

E. A PROPOSED CLASSIFICATION OF INSIDER TRADING POLICIES

Based on a random 10% sample of the S&P 1500, company insider trading policies vary widely based on their content and level of disclosure. To examine their contents and relative advantages and disadvantages, a classification of these policies is useful. Since these policies are necessarily limited by disclosure, this Note classifies them according to their level of disclosure. These policies were found on the websites of the companies within the sample, and many insider trading policies can be found in corporate codes of conduct or ethics.

i. Nondisclosure

The first category is that of undisclosed or non-disclosed policies. This category refers to policies that are simply unavailable on the company website. Markedly, this category is the smallest since most companies offer some level of information regarding their policies. One example is General Mills, Inc., which offers neither a code of conduct nor a specific insider trading policy.[170] Some companies provide a code of conduct or ethics but omit references to insider trading, such as CIRCOR International, Inc.[171]

ii. Partial Disclosure

The second most common category is that of partial disclosure. Companies within this category briefly address insider trading in their codes

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168. *Id.*

169. *Id.*

170. *Corporate Governance Principles,* GENERAL MILLS (Sept. 28, 2021), https://investors.generalmills.com/corporate-governance/governance-documents/default.aspx; *see also* FUTURE FUEL CORP., https://futurefuelcorporation.com/ (last visited Mar. 3, 2023).

171. *Code of Conduct & Business Ethics*, CIRCOR INT'L (2022), https://investors.circor.com/static-files/c81bbed5-8970-4ad9-9dd0-a715fac4e1e5; *see also Code of Ethics*, VIAD CORP, https://s21.q4cdn.com/760353948/files/doc_downloads/doc_charters/CodeofEthics.pdf; *Code of Business Conduct and Ethics*, LEGGETT & PLATT (Nov. 4, 2021), https://leggett.com/governance/business-conduct.

of conduct or ethics but allude to a more detailed, unavailable policy. These provisions often include a hyperlink to other documents requiring employee credentials for access, or the referenced document is absent on the company website. However, policies within this category further vary regarding the contents of the available information.

Within partial disclosure, some policies briefly state that insider trading is prohibited and allude to another policy. Kroger, for example, states that "[n]o director or associate may buy or sell securities of a company if that person has material nonpublic information relating to that company," and then includes a hyperlink to a policy that is only accessible with an employee login.[172] Similarly, NVIDIA Corporation mentions a prohibition on insider trading unless under the protection of a Rule 10b5-1 plan and then includes hyperlinks to a specific policy, an FAQ, and 10b5-1 Trading Plan Guidelines.[173] However, the hyperlinks do not work. Other corporations mention an insider trading policy but do not include a link.[174]

Other policies reference an insider trading policy but include more information about the prohibitions and procedures the company has in place. Dycom Industries, Inc., explains insider trading, materiality, and tipping, and explains its illegality and that violations are punished civilly and criminally.[175] Dycom also prohibits trading on MNPI until the information is public.[176]

On the more extreme end, NASDAQ, Inc., refers to a policy and broad prohibitions.[177] NASDAQ explains insider trading, materiality, and "associated persons" that are also covered by the policy and that specific types of associates and corporate officials are subject to further restrictions.[178] Next, it states that the policy covers publicly traded stocks, bonds, and so on and that this definition may be expanded by "supplemental policies" to include other types of securities.[179] These covered types of securities are subject to a list of prohibited companies, minimum hold times before which

172. *The Kroger Co. Policy on Business Ethics*, KROGER, https://www.thekrogerco.com/wp-content/uploads/2017/09/business-ethics-policy.pdf.

173. *Our Code*, NVIDIA, https://s22.q4cdn.com/364334381/files/doc_downloads/governance_documents/Worldwide_Code_of_Conduct.pdf.

174. *See, e.g.*, *Code of Business Ethics*, REALTY INCOME CORP., https://s21.q4cdn.com/421822989/files/doc_downloads/investors/corporateGovernance/Code-of-Business-Ethics-7-24-18.pdf; *Standards of Conduct and Ethics for Employees, Officers and Directors*, MOHAWK INDUS., INC., http://ir.mohawkind.com/static-files/8def008c-74ff-45be-849a-76a10db41785; *Code of Business Conduct and Ethics*, M&T BANK CORP. (last amended Oct. 20, 2020), https://ir.mtb.com/static-files/1c8c627e-2938-46a4-97cc-44aacb613f91.

175. *Code of Business Conduct and Ethics,* DYCOM INDUS., INC. (Nov. 11, 2022), https://ir.dycomind.com/static-files/254301d5-c942-4593-9ef3-0b662247dabd.

176. *Id.*

177. *Code of Ethics*, NASDAQ, INC., https://ir.nasdaq.com/static-files/aca3c338-f7ad-4f31-ae69-ef3a8d36fa6d.

178. *Id.*

179. *Id.*

employees cannot sell, and prohibitions on short sales unless approved.[180] Regarding NASDAQ securities, employees must disclose all accounts and holdings, may only trade during delineated trading windows, are prohibited from short-selling, and may be suspended from trading by the company.[181]

iii. Full Disclosure

The last category is that of full disclosure. A policy is fully disclosed if it is available as a standalone insider trading policy that is separate from the code of conduct and that does not allude to a more detailed yet unavailable policy.[182] Documents within this category tend to be highly detailed.

Pool Corporation's insider trading policy is one of full disclosure.[183] It prescribes two full trading days for information to absorb into the market, quarterly and event-specific blackout periods during which trading is prohibited,[184] and preclearance procedures.[185] Pool Corporation also prohibits short term trading of its stock, short sales, hedging, and purchase or sale of options.[186] Lastly, it explains the civil and criminal penalties imposed for insider trading and states that employees may be liable for sanctions or termination by the corporation.[187]

F. Discussion of Disclosure Levels and Effective Compliance Programs

An advantage of nondisclosure is the freedom to amend an insider trading policy without being held accountable for it by investors. However, the SEC considers this accountability a necessary component of preventing and

180. *Id.*; Adam Hayes, *Short Selling*, INVESTOPEDIA (Sept. 23, 2021), https://www.investopedia.com/terms/s/shortselling.asp ("Short selling occurs when an investor borrows a security and sells it on the open market, planning to buy it back later for less money.").

181. NASDAQ, *supra* note 161.

182. By virtue of companies' selective disclosure, full disclosure is speculative. It is possible that a relatively detailed policy is disseminated to the public and that a separate policy is held internally. Many standalone insider trading policies are heavily detailed, so this possibility may be small, but it is still worth noting.

183. *Insider Trading Policy*, POOL CORP., https://s3.amazonaws.com/b2icontent.irpass.cc/603/183902.pdf?AWSAccessKeyId=1Y51NDPSZK99KT3F8VG2&Expires=1640552749&Signature=OhHW9XV96Nx3x8zbZuW%2FPV8AMkY%3D.

184. Christina Majaski, *Blackout Period*, INVESTOPEDIA (Apr. 15, 2021), https://www.investopedia.com/terms/b/blackoutperiod.asp ("A blackout period is a policy or rule setting a time interval during which certain actions are limited or denied. It is most commonly used to prevent company insiders from trading stock based on insider knowledge.").

185. POOL CORP., *supra* note 167; WILLKIE FARR & GALLAGHER LLP, *Trading Preclearance Windows and Blackout Periods*, https://complianceconcourse.willkie.com/resources/insider-trading-compliance-programs-trading-preclearance-windows-and-blackout-periods (last visited Dec. 26, 2021) ("Preclearance policies prohibit employees and agents from engaging in any transaction involving the firm's or other securities without first obtaining preclearance of the transaction from the firm's chief compliance officer, chief financial officer, or some senior officer with similar responsibilities.").

186. POOL CORP., *supra* note 167.

187. *Id.*

pursuing insider trading.[188] This nondisclosure may reduce investor confidence, though companies likely have policies in place. Alternatively, high disclosure obligates companies to adhere to high procedural standards. Many companies may offer partial disclosure as a means of managing both extremes. Regardless of the purpose and level of disclosure, these policies vary greatly, and companies are encouraged to develop tailored policies depending on their "operation, industry, and employee base."[189]

Preclearance procedures have positive effects on reducing informed trading. A 2011 study found that "active monitoring" of corporate general counsel under preclearance programs is associated with a reduction in insider trading profits.[190] Preclearance measures serve three important purposes: (1) they protect companies against allegations of negligence in connection with insider trading violations; (2) they protect directors and officers by reducing the likelihood of unintentional insider trades; and (3) they allow the company to access the trading activities of directors and officers, thus enforcing compliance.[191] Luckily, about 80% of companies surveyed had preclearance measures in place when the study was conducted.[192]

Additionally, a study published in 2000 found that blackout periods and trading windows are extremely effective at curbing insider trading and result in "greater liquidity" of companies' shares.[193] When the study was conducted, nearly 80% of firms had explicit blackout periods.[194]

Along with blackout periods, trading windows, and preclearance procedures, companies can mitigate the risks of shadow trading by implementing lists of prohibited companies like NASDAQ and by educating employees about insider trading. Instead of disseminating this list, companies can allow only general counsel and executives involved in approving transactions to have access to it. This manages the sensitivity of its contents, allows companies to decide which companies are economically linked, and may include discretionary provisions to allow for flexibility and expansion.

III. VAN BUREN V. UNITED STATES AND OTHER SOLUTIONS

A. VAN BUREN V. UNITED STATES

In June of 2021, the Supreme Court decided *Van Buren v. United States*—an analogous case within the context of the Computer Fraud and Abuse Act (CFAA). Van Buren was a former police sergeant who befriended

188. *See generally* SEC Exchange Act Release, *supra* note 168.

189. Jay A. Dubow & John Shasanmi, *The Importance of Having and Following a Strong Public Company Insider Trading Policy*, BUSINESS LAW TODAY (Oct. 2011), https://www.jstor.org/stable/10.2307/businesslawtoday.2011.10.01; SEC Exchange Act Release, *supra* note 150.

190. Jagolinzer et al., *supra* note 157, at 1249, 1271.

191. Dubow & Shasanmi, *supra* note 189.

192. Jagolinzer et al., *supra* note 157, at 1271.

193. Bettis et al., *supra* note 146, at 218.

194. *Id.*

a "very volatile" man named Albo, who concocted a scheme with the FBI "to see how far Van Buren would go for money."[195] As part of this scheme, Albo would have offered Van Buren $5,000 to search his police database for the license plate of a woman Albo met at a strip club to ensure that she was not an undercover officer.[196] The plan went off without a hitch, Van Buren found the license plate created by the FBI, and the federal government charged Van Buren with a felony violation of the "exceeds authorized access" clause of the federal CFAA.[197]

By using this database outside the scope of his work, which he was trained not to do, the trial court found that Van Buren knowingly violated department policy.[198] Moreover, the government asserted that this policy breach constituted a violation of the CFAA because the use of this database "for a non-law-enforcement purpose" exceeded his authorized access, which was only supposed to extend to job-related searches.[199] Van Buren was convicted and sentenced to eighteen months in prison.[200] On appeal, Van Buren argued that "the 'exceeds authorized access' clause applies only to those who obtain information to which their computer access does not extend, not to those who misuse access that they otherwise have."[201] Van Buren won the appeal, and the Supreme Court affirmed, finding that the government's interpretation would "criminalize[] every violation of a computer-use policy" made by "millions of otherwise law-abiding citizens."[202]

Orin Kerr, Van Buren's attorney, argued that because the federal government lacked the means of "stopping insiders from misusing sensitive information," it relied on an expanded interpretation of the CFAA to compensate but could not do so without criminalizing harmless conduct.[203] Instead, Kerr posits that Congress should "enact a new criminal law specifically about insider abuse of sensitive government databases."[204]

B. SOLUTION

This Note suggests that the outcome of the enforcement of shadow trading under Rule 10b-5 should follow that of *Van Buren.* Like *Van Buren*, the SEC seeks to enforce internal policies as violations of federal law—an outcome the Supreme Court rejected. Here, broad consequences are also involved; insiders could face federal consequences for conduct others do not,

195. Van Buren v. United States, 141 S. Ct. 1648, 1653 (2021).
196. *Id.*
197. *Id.*
198. *Id.*
199. *Id.*
200. Van Buren v. United States, 141 S. Ct. 1648, 1653 (2021).
201. *Id.*
202. Van Buren v. United States, 141 S. Ct. 1648, 1661 (2021).
203. Brief for Petitioner at 24–26, Van Buren v. United States, 141 S. Ct. 1648 (2021) No. 19-783 [hereinafter Van Buren Petitioner Brief].
204. *Id.* at 27.

and corporations would wield the power of federal law. Thus, insider trading policies should not be federally enforced.

While Orin Kerr suggested a new law because of the lack of existing alternatives, there are other means of pursuing shadow trading under current law without enforcing company policies. The SEC can pursue shadow trading under misappropriation theory using the *Basic Inc.* notion of materiality, as it does in the *Panuwat* complaint, but treat corporate policies as separate contracts with remedies for breach. This solution offers responsible companies further protection against trading by their employees and incentivizes employees to comply. Because there are other means of pursuing shadow trading under existing law, a statutory solution, such as the ITPA, may not be necessary.

Lastly, companies can internally reduce instances of informed trading through effective compliance policies. Programs including preclearance requirements, private lists of prohibited companies, blackout periods, trading windows, and adequate employee education can aid the SEC, protect companies and insiders from liability, maintain investor confidence, and enhance liquidity of companies' shares.

CONCLUSION

The SEC's enforcement of shadow trading in *SEC v. Panuwat* poses a problem by enforcing Medivation's insider trading policy as a violation of Rule 10b-5. This shifts legislative authority to corporations and will cause insiders to face dissimilar consequences for similar conduct. The outcome of an analogous case, *Van Buren v. United States*, suggests that such enforcement of insider trading policies would likely not be endorsed by the Supreme Court. Instead, the SEC should enforce shadow trading via misappropriation theory and the *Basic Inc.* notion of materiality and treat company policies as separate contracts. Companies can also do their part to mitigate instances of shadow trading by enacting effective insider trading policies. This combination of effective corporate governance, the treatment of internal policies as contracts, and SEC enforcement should help to control instances of insider trading while ensuring that the outcomes for violations are uniform.

Kayla Kershen[*]

* *J.D. Candidate 2023*, *Brooklyn Law School*; *B.A. 2020*, *Oakland University*. Thank you to Professor Andrew Jennings, who provided mentorship on this project; to Professors Edward Janger, Jayne Ressler, and Carrie Teitcher for their support throughout my law school career; and to the diligent members of the *Brooklyn Journal of Corporate, Financial & Commercial Law* for their hard work. Last, but not least, thank you to my family and friends for their encouragement and unwavering support in everything I do.