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SEC Breaks New Ground with "Shadow Trading" Prosecution

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On August 17, the Securities and Exchange Commission (SEC) filed a civil enforcement action in the United States District Court for the Northern District of California against former Medivation Inc. executive, Matthew Panuwat. The SEC alleges that Panuwat, as an insider of Medivation, had access to material non-public information, specifically that Medivation would shortly be acquired by Pfizer, and that Panuwat used that inside information to engage in securities trades resulting in illicit profits of $107,066.

What sets the Panuwat prosecution apart from run-of-the-mill insider trading cases is that Panuwat is not alleged to have used his insider information to trade Medivation or Pfizer stock. Instead, Panuwat is accused of using his knowledge of the upcoming Pfizer acquisition to purchase stock options in one of Medivation's competitors, Incyte Corporation. The SEC's Complaint, available here, alleges that Panuwat received confidential, material, non-public information about the Pfizer acquisition of Medivation and, within minutes, used that information to purchase stock options in Incyte. The SEC alleges that Panuwat believed that Pfizer's acquisition of Medivation would cause Incyte's stock price to increase, which proved true. The day that Pfizer's acquisition of Medivation was announced, Incyte's stock price increased by roughly 8%, doubling the value of Panuwat's stock options.

The SEC alleges that Panuwat knew or was reckless in not knowing that information about the acquisition was material and non-public, not only for Pfizer and Medivation, but also for Incyte. As such, the SEC alleges that Panuwat misappropriated the information by trading on it for his own benefit.

This type of trading – using non-public information about one company to trade stock in another unrelated company in the same or overlapping industry – is most often called "shadow trading." As the name implies, this type of trading behavior has been discussed as potentially illicit in securities literature for years. However, numerous media reports indicate this is the first case actually filed by the SEC in federal court based on shadow trading.

If the SEC is successful in this case, it will have significant repercussions for public companies as well as investment banks, broker/dealers, and other professionals who may come into contact with material, non-public information about such companies. All such companies should monitor the Panuwat prosecution carefully, as the outcome may have major impacts on companies' insider-trading policies.