

Insider trading or something else? Shadow trading steps out of the darkness

January 24, 2025

There is a spotlight on “shadow trading” because of a United States Securities and Exchange Commission (SEC) decision marking its first success in asserting this new insider-trading theory. Shadow trading occurs when a person with insider information about one company purchases the securities of an economically linked company (e.g. a competitor) under the expectation that the trading prices of the economically linked company’s securities will be influenced by the insider information, often due to similar market conditions, shared industry dynamics, or direct competition.

What does this mean in Canada? Québec’s securities legislation expressly prohibits shadow trading, though the other provinces and territories do not specifically prohibit it. Nonetheless, the securities regulators’ powers to prosecute actions that are contrary to the public-interest jurisdiction can be used to allow them to impose sanctions in the context of shadow trading if there has been harm to the public interest.

What is shadow trading?

Shadow trading involves the use of material non-public information (MNPI) of a reporting issuer to profit from trading the securities of a distinct but “economically linked” company. An economic link exists where an issuer’s financial performance or market value is closely related to another issuer. The fulcrum of shadow trading is identifying a market connection between Company A, whose MNPI is accessed, and Company B, whose securities are traded, without relying on direct insider information about Company B.

Shadow trading has become a topic of discussion in the United States in recent years. An [article from the Fordham Journal of Corporate & Financial Law](#) recently discussed the need for legislative amendments to address shadow trading. Another U.S. study suggested that an estimated US\$2.75 billion in shadow-trading transactions occurred between 2009 and 2021 whereby insiders purchased ETFs that contained the insider company, sidestepping the relevant insider trading provision.

However, the distinction between the Canadian and U.S. ETFs regimes becomes important when analyzing the extent and impact of shadow trading in the Canadian markets. While in the U.S. ETFs make daily public portfolio disclosure, Canadian ETFs

are not mandated to do so. This difference in disclosure, lessens the risk of shadow trading occurring in our ETF market.

Insider trading: Canada

In Canada, both the federal Criminal Code (the Criminal Code) and provincial securities legislation prohibit insider trading, tipping, and more recently, recommending the purchase of a security to a third party (collectively, these are all considered forms of “insider trading”). **Generally, insider trading involves the purchase or sale of securities** with knowledge of MNPI with respect to a particular issuer. This may include instances where the MNPI relates to two issuers, for example, in a yet-to-be-disclosed M&A transaction. Tipping occurs when a person informs another person, other than in the necessary course of business, of MNPI about an issuer. Recommending, which occurs when a person in possession of MNPI recommends or encourages another to purchase or sell securities, is likewise prohibited. The purpose of these prohibitions is to promote fair and efficient capital markets in which all participants have equal access to information when making investment decisions. Insider trading is a serious offence and can result in substantial penalties, including fines and bans from trading and the capital markets.

Shadow trading in Canada

While shadow trading is not explicitly captured by Canadian insider trading prohibitions **(with the exception of in Québec), the securities regulators in Canada have a broad public interest jurisdiction to impose orders.** The securities regulators in Canada have used these powers to impose sanctions on conduct that is contrary to the public interest, including in insider trading cases, despite the conduct not technically contravening the express language of the law.

For example, the Ontario Securities Commission (OSC) addressed allegations of insider trading and conduct contrary to the public interest in [Re Donald \(2012\)](#). In this case, the **insider trading allegations centered on Donald’s special relationship with Certicom Corp.** (Certicom). As an employee of Research in Motion (RIM), Donald had accessed MNPI from RIM’s Strategic Alliances Group about RIM’s interest in acquiring Certicom. Donald used this MNPI - which indicated Certicom’s undervaluation - to make personal trades in Certicom shares.

Ultimately, the OSC determined that Donald’s conduct was not contrary to the insider trading prohibition under Ontario’s securities legislation. This was because RIM was not proposing a takeover of Certicom, meaning that Donald could not be in a special relationship with Certicom (a requirement of the prohibition). However, the OSC found **Donald’s conduct to be contrary to the public interest due to the misuse of MNPI and the potential damage to market integrity caused by his actions.** The OSC imposed a five-year prohibition on Donald participating in the capital markets as a director or officer of a reporting issuer, but held short of imposing a trading ban.

This decision highlights that the various Canadian securities commissions could restrict shadow trading through the public interest authority even when shadow trading is not being captured by the express language of the securities legislation.

Unlike in the other provinces and territories, Québec's securities legislation explicitly addresses conduct that would include shadow trading. Section 189.1 of the Securities Act (Québec) prohibits the use of MNPI of one issuer to trade in another issuer's securities, options or derivatives, if their market prices are likely to be influenced by the price fluctuations of the first issuer's securities.

The SEC's win on shadow trading

On April 5, 2024, the SEC secured a major win in its widely publicized litigation against Matthew Panuwat, a former executive at Medivation Inc. (Medivation), marking the first successful shadow insider trading action in the United States. A federal jury ruled that Panuwat engaged in insider trading by purchasing securities of a competitor to Medivation, based on MNPI that Medivation was going to be acquired by Pfizer at a significant premium.

Seven minutes after learning this information, Panuwat bought short-term, out-of-the-money call options in Incyte Corp., a pharmaceutical company that was a direct competitor to Medivation. **When the Pfizer-Medivation deal was announced, Incyte's stock jumped 8 per cent, resulting in Panuwat making a profit of over US\$100,000.**

The SEC proved a market connection between Medivation and Incyte by showing that **Panuwat knew Medivation's investment bankers viewed Incyte as a comparable company.** The SEC also cited numerous analyst reports, financial news articles, and investment banker analyses that described Medivation and Incyte as a comparable company. **The SEC used evidence that the trading price of Incyte's stock jumped on the disclosure of the Medivation deal as de facto evidence that the two companies were economically linked.**

At trial a jury found Panuwat liable of insider trading. On September 9, 2024, the Court imposed the maximum penalty available by the SEC, in the amount of \$321,197.40, or **three times the amount of Panuwat's profits.** However, the Court held short of imposing the SEC recommended penalty of banning Panuwat from serving as a director of officer of a public company for life. The Court also rejected Panuwat's request for a new trial.

Insider trading laws in the United States

Unlike in Canada, where insider trading is expressly prohibited in all provinces and territories within the language of the relevant securities legislation, the United States prohibits insider trading through the expansion of the anti-fraud provision of the Securities Exchange Act of 1934. **This prohibits "any manipulative or deceptive device... in connection with the purchase or sale of any security."** Over time, the Supreme Court of the United States has expanded the interpretation of this provision to include a prohibition on insider trading and with the Panuwat case, a prohibition on shadow trading.

Conclusion

The Panuwat Decision expanded the scope of insider trading to include shadow trading in the United States. In Canada, we have seen the securities regulators expand the

prohibition on insider trading found in securities legislation using their public-interest powers, such as in the Certicom decision.

Shadow trading could be subject to a range of sanctions in Canada under the public-interest authority outside of Quebec and under specific prohibitions in the securities legislation in Quebec. As such, reporting issuers, registrants and other securities-industry participants should review their insider trading policies and education programs to confirm that shadow trading is adequately addressed.

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