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Using this study guide.

This study guide is intended for use prior to attempting the accompanying exam. Read the complete study guide at your convenience before beginning the exam. You may cover the material in one session or break the material into several shorter sessions, whichever best fits your learning style. All answers to exam questions are covered in this document.

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Insider Trading

Definition

Insider trading involves the purchase or sale of securities, puts, calls or other options based on material nonpublic information. The trading may be deemed “insider” if those involved have any beneficial interest (direct or indirect) in the securities or options regardless of whose name is actually on the paperwork. Tipping is included under the umbrella of insider trading if inside information is revealed to outside individuals in order to enable said individuals to trade in the securities based on undisclosed information.

The person who trades or tips information is in violation of the law if he/she has a fiduciary duty or other relationship of confidence not to use the information. To be guilty of insider trading or tipping, the accused must have breached a duty to someone in the acquisition of material nonpublic information that leads to a securities transaction. The breach of duty alone does not constitute a violation of the statutes used to prosecute insider trading. The breach of duty must be accompanied by some type of deception or manipulation.

Legal Basis

Current-day liability for insider trading comes mostly from Section 10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b-5. Section 10 (b) sets forth that “It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange... (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.” Rule 10b-5 states: “It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange, (a) To employ any device, scheme, or artifice to defraud, (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading...” In clearer

language, these rules simply prohibit making false statements or omitting material facts related to the purchase or sale of securities. Both 10(b) and 10b-5 have been interpreted to mean that in certain settings one cannot buy or sell securities of a company about which one has material, nonpublic information or tip others to buy or sell on the basis of such information, but neither rule specifically mentions insider trading.

Section 14(e)-3 of the Exchange Act similarly prohibits misrepresentations and other “fraudulent, deceptive, or manipulative acts or practices” in connection with tender offers. This regulation bans the trading in securities of a tender offer target by any person other than the bidder who is in possession of material, nonpublic information relating to the tender offer that he knows, or has reasons to know, was acquired directly or indirectly from the bidder, the target or those acting on behalf of either. These prohibitions apply even if the person charged with the violation does not owe a duty to the issuer or its shareholders and even if no prohibition against misappropriation has been violated. Thus, the SEC, in adopting Rule 14e-3, has explicitly prohibited insider trading in connection with tender offers. Similarly, insider trading is expressly regulated in Section 16 of the Exchange Act. This section prohibits “short swing” trading by officers, directors, and the direct or indirect beneficial owners of more than 10% of any class of equity securities.

The federal mail fraud statute and the wire fraud statute have been used in criminal prosecutions involving Rule 10b-5. The mail statute prohibits the “use” of mail to further any “scheme or artifice to defraud” anyone of property. The wire fraud statute prohibits the “use” of wire, radio or television to defraud. Both statutes may continue to be used in prosecuting suspected insider traders.

Likewise, the Racketeer Influenced and Corrupt Organizations Act (RICO) has often been used to prosecute insider-trading violations. RICO prohibits the infiltration of any interstate commerce enterprise by those who have “a pattern of racketeering activity.” Two or more acts of “any offense involving...fraud in the sale of securities,” including mail and wire fraud constitutes racketeering activity. RICO has given plaintiffs a way to circumvent the limitations of the federal securities laws.

Insiders

All those who come into possession of material inside information before it is publicly released are considered insiders. This includes control stockholders, directors, officers, employees, and others. The company itself is an insider and when it has material inside information, may not legally buy its securities from or sell its securities to the public. Cases of insider trading most frequently involve corporate officers and directors. They are restricted in trading the securities of their own company or are obligated not to disclose any material nonpublic information entrusted to them.

Those who receive inside information in confidence can include a vast array of people involved in the securities industry such as investment bankers, attorneys, law firm employees, accountants, bank officers, brokers, financial reporters, public relations advisors, advertising agencies, consultants and other independent contractors. In the past, the SEC has even charged a psychiatrist with insider trading violations.

A significant number of cases are investigated and litigated each year. The SEC can seek a court order against violators and can obtain orders that force them to disgorge their trading profits as well as seek penalties in an amount up to three times the trading profits. The Insider Trading and Securities Fraud Enforcement Act of 1988 can also hold corporations, brokerage firms or other “controlling persons” who supervise a violator liable. A supervisor may be prosecuted if he/she knew or recklessly disregarded the fact that the violator was likely to engage in insider trading and failed to attempt the prevention of such action. Informants who provide information leading to successful prosecution against inside traders may be given bounties of up to 10% of the penalties recovered.

Inside Information

According to the American Stock Exchange Company Guide, inside information is any information or development which may have a material effect on the company or market for its securities and which has not been publicly disclosed. Such information originates from within a corporation and is meant for corporate purposes only such as data relating to corporate operations, finances, or prospects. A broader definition of inside information is any material information that could not be found by diligent research of public record. Clear differences between market information (such as knowledge of a

potential takeover) and inside information have become increasingly blurred. In the past, the Second Circuit has upheld convictions of insider trading based on misuse of “market information.”

Material Information

To become the basis of insider trading, information must be important enough to be considered “material.” The Supreme Court ruled on materiality in the *TSC Industries v. Northway* case (426 U.S. 438, 449 96 S.Ct. 2126, 48 L.Ed.2d 757). An omitted fact is material if it is substantially likely that a reasonable investor would consider it important in making an investment decision. That is, “there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the ‘total mix’ of information made available.” The standard for materiality is objective and makes use of the “reasonable man” notion of common law torts.

The degree of specificity of the nonpublic information can affect its materiality. In the case of *SEC v. Monarch Fund* (608 F. 2d 938), the court ruled that the information in question “lacked the basic elements of specificity.” That is, the lenders were not identified, no date was given for the financing, and no specific terms were divulged, so the information was not considered material.

Scienter

In the case of *Ernst & Ernst v. Hochfelder* (425 U.S. 185, 193-194 n.12, 96 S.Ct. 1375, 47 L.Ed. 2d 668), the Supreme Court ruled that insider trading must involve “scienter,” a “mental state embracing intent to deceive, manipulate, or defraud.” It is commonly assumed that scienter is present if the speaker knows that the information he is conveying is wrong or contains an omission and appreciates its propensity to mislead. It is further assumed that the statements of a corporation’s agent acting within the scope of his authority are attributed to the corporation. Negligence will not satisfy the scienter requirement, but recklessness is sufficient for a 10(b) or 10b-5 claim.

Prevention

Smart companies generally caution employees to be careful when they trade so SEC rules are not violated. In order to avoid the appearance of improper trading, some companies enforce stringent procedures for the purchase and sale of its securities by officers, directors, employees and other insiders. One example is allowing corporate insiders to purchase and sale the company's securities only after the release of annual statements and other public announcements explaining the financial status of the corporation. Another way a company can decrease the probability of insider trading is by contracting with a third party agent who will buy and sale only on a regular periodic basis without any input from the company or the individual employee. Largely, the SEC rules discourage insiders from trading their own securities very often.

When material information is legally withheld temporarily (per Exchange policy), every caution must be exercised to maintain the confidentiality of the information withheld because the likelihood of insider trading increases proportionately to the number of people trusted with the undisclosed information. In its Listed Company Manual, the NYSE dictates that extreme care should be used in this situation. Employees, directors and officers must be routinely reminded not to disclose or use any nonpublic information. The Exchange further suggests that reviews of company policies related to confidentiality be held periodically.

Insider purchases and sales are closely watched and the data is published by several sources. Bloomberg Columns Insider Focus, The SEC and Thomson Market Edge are involved in this process, but the data can be very misleading to the general public. Interpretation is very difficult and much study of a company's last two years of business is needed to draw any worthwhile conclusions.

Kardon v. National Gypsum Co.

In the case of *Kardon v. National Gypsum Co.* (73 F. Supp. 798), the court's position was that Section 10(b) of the Exchange Act and SEC Rule 10b-5 require corporate insiders to disclose material information or refrain from trading based on the existence of a corporate or trust relationship which gave the insider access to undisclosed information intended only for specific business purposes. The "fraud" was predicated on abuse of a personal liability to maintain confidentiality.

In re Cady, Roberts & Co. (40 S.E.C.907)

This landmark case of 1961 expanded the liability of Rule 10b-5 by banning all securities trading based on the misuse of inside information, including those handled by independent securities market representatives. This was the first case of a non-insider being convicted after he received a tip from the director of a public company. It was also the first example of Rule 10b-5's application to an impersonal market trade with no pre-existing personal relationship of trust involved.

U.S. v. Chestman

The first significant use of Rule 14e-3 in a criminal conviction was with *U.S. v. Chestman* (947 F. 2d 551). Robert Chestman was found guilty of trading Waldbaum, Inc. securities in advance of a tender offer by Great Atlantic & Pacific Tea Co. by using material nonpublic information given to him by a member of the Waldbaum family who was not a fiduciary of the company.

U.S. v. O'Hagan

Former Minneapolis attorney James O'Hagan was accused of insider trading after he earned more than \$4.3 million by trading Pillsbury stock. O'Hagan's law firm was hired by Grand Metropolitan PLC, a British company planning an attempt to take over Pillsbury. O'Hagan's lawyer maintained his client's innocence because O'Hagan did not work for Pillsbury and owed no legal duty to the company or its stockholders. O'Hagan was convicted, but appeals kept the case in court for several years. In 1997, the Supreme Court upheld the convictions and ruled that citizens can be guilty of using inside information to buy or sell a company's securities even if they don't work for the

corporation or owe it any legal duty. Justice Ruth Bader Ginsburg wrote, “It is a fair assumption that trading on the basis of material, nonpublic information will often involve a breach of duty of confidentiality to the bidder or target company or their representatives.”

By upholding the conviction of a non-employee, the Court supported the SEC’s broadened definition of insiders and adopted the Commission’s view of what is required to show violations of insider trading. In April of 1998, the Court of Appeals held that as related to Section 10(b) and Rule 10b-5, “*willfully* simply requires the intentional doing of a wrongful act --- no knowledge of the rule or regulation is required.” (139 F.3d 647) It further held that “acts occurring after a substantial step towards a tender offer has been made qualify as acts occurring in connection with a tender offer” and a defendant is not required to have knowledge of the steps toward the tender offer. (139 F.3d 647)

O’Hagan was also convicted of mail fraud although he argued that his mailing of confirmation slips was in an effort to adhere to Rule 10b-10. The court’s ruling was that Rule 10b-10 requires brokers to provide written confirmation, but does not necessitate mailing the slips. The court ruled that O’Hagan’s confirmation slips helped him keep track of his purchases and thereby furthered his scheme to defraud.

This case was very important to the SEC because the convictions based on 10(b), 10b-5 and 14(e) were upheld and Section 14(e) can continue “to be a broad antifraud remedy in the area of tender offers” as Congress intended. (139 F.3d 647)

SEC v. Adler

In the case of *SEC v. Adler* (137 F.3d 1325), the Eleventh Circuit rejected the SEC’s proposal that possession of inside information is sufficient for an insider trading conviction by a corporate insider. The court ruled that there must be a causal connection between the inside information and the trade. That is, the defendant must actually use the information in question to be guilty of insider trading.

U.S. v. Smith

In the case of *U.S. v. Smith* (155 F.3d 1051), the question of use versus possession was re-addressed. The court's decision held that proof of trading while in possession of material nonpublic information must be coupled with use of the information in the trade.

SEC v. Warde

In the case of *SEC v. Warde*, (151 F.3d 42), the Court of Appeals for the Second Circuit ruled that a tipper of inside information who hopes to benefit a recipient by passing along material nonpublic information is guilty of insider trading. It is not necessary for the tipper to expect or receive any benefit for the tip.

Conclusion

Many questions remain regarding the intent of the laws relating to insider trading. There will likely be continued litigation involving these issues because interpretation of existing rules and regulations is controversial within the industry.



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