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FINANCIAL SERVICES

Insider Trading: A Primer

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In the wake of the increased focus by the Securities and Exchange Commission (SEC) on insider trading cases, there appears to be a heightened interest in enforcing prohibitions on insider trading. This is a good time to provide a short primer on insider trading and a reminder of the need to have safeguards in place to protect against insider trading.

Generally

"Insider trading" is not defined in the federal securities laws, but insider trading laws have developed through SEC and court interpretations of Section 10(b) of the Securities Exchange Act of 1934, as amended, prohibiting use of a "deceptive device" and the anti-fraud provisions of Rule 10b-5 promulgated thereunder. Insider trading is considered a "deceptive device" and generally includes using material non-public information to trade in securities either personally or on behalf of another (whether or not one is an "insider") or communicating material non-public information to others. The laws pertaining to insider trading encompass (a) trading by an insider while in possession of material non-public information; (b) trading by a non-insider while in possession of material non-public information, where the information either was disclosed to the non-insider in violation of an insider's duty to keep it confidential or was misappropriated; and (c) communicating material non-public information to others.

Who Is an Insider?

The concept of an "insider" is broad and includes officers, directors and employees of an issuer. In addition, a person can be a "temporary insider" if he or she enters into a special confidential relationship with the issuer and, as a result, is given access to confidential information. A temporary insider can include an issuer's attorneys, accountants or consultants.

What Is Material Information?

Trading on inside information is not a basis for liability unless the information is material. "Material information" generally is defined as information for which there is a substantial likelihood that a reasonable investor would consider it important in making his or her investment decisions, or information that is reasonably certain to have a substantial effect on the price of an issuer's securities. Material information can be positive or negative and can relate to virtually any aspect of a company's business or to a type of security.

Material information does not have to relate to an issuer's business. For example, in *Carpenter v. U.S.*, 484 U.S. 19 (1987), the Supreme Court considered material certain information about the contents of a forthcoming newspaper column that was expected to affect the market price of a security. In that case, a *Wall Street Journal* reporter was found criminally liable for disclosing to others the dates that reports on various companies would appear in the Journal and whether those reports would be favorable or not.

If you have any questions or would like assistance in reviewing your current compliance program or in educating your employees on the nuances of insider trading, please contact:

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What Is Non-Public Information?

Information is non-public until it has been effectively communicated to the marketplace. One must be able to point to some fact to show that the information is generally public. For example, information found in a report filed with the SEC or appearing in The *Wall Street Journal* or other publications of general circulation, or on a quotation service such as *Bloomberg*, would be considered public. General release of the information over a computer-based news service, in a corporate communication to shareholders or in a widely distributed prospectus, followed by the passage of adequate time for the investing public to absorb such information, normally constitutes adequate disclosure. The circulation of rumors, however, even if they turn out to be accurate, does not constitute sufficient public disclosure. Information is not adequately disclosed to the public merely because a finite number of persons in the investment community may be aware of it.

Material information that is communicated under circumstances indicating that it has not been widely disseminated or where the recipient knows or suspects that it has been provided by an inside source should be treated as non-public information.

Bases for Liability

Generally speaking, there are two theories of liability for trading on material non-public information:

1. Fiduciary Duty or "Classical" Theory

Under the fiduciary or "classical" theory, liability arises when a corporate insider trades in the securities of his or her corporation on the basis of material non-public information. There is no general duty to disclose before trading on material non-public information, but such a duty arises only where there is a fiduciary relationship. That is, there must be a relationship between the parties to the transaction such that one party has a right to expect that the other party will disclose any material non-public information or refrain from trading. *Chiarella v. U.S.*, 445 U.S. 222 (1980).

In *Dirks v. SEC*, 463 U.S. 646 (1983), the Supreme Court discussed alternative theories under which non-insiders can acquire the fiduciary duties of insiders: (i) non-insiders can enter into a confidential relationship with the issuer through which they gain information (e.g., attorneys, advisers or accountants); or (ii) non-insiders can acquire a fiduciary duty to the issuer's shareholders as "tippees" if they are aware or should have been aware that they have been given confidential information by an insider who has violated his or her fiduciary duty to the issuer's shareholders.

A "tippee's" liability for insider trading is no different from that of an insider. Tippees can obtain material non-public information by receiving overt tips from others or through, among other things, conversations at social, business or other gatherings.

2. Misappropriation Theory

Another basis for insider trading liability is the "misappropriation" theory, first recognized by the Supreme Court in *United States v. O'Hagan*, 521 U.S. 642 (1997). Under the misappropriation theory, liability arises when trading occurs on material non-public information that was stolen or misappropriated from any other person in breach of a duty owed to the source of the information. The misappropriation theory premises liability on a trader's deception of the person who entrusted him or her with access to confidential information. It should be noted that the misappropriation theory can be used to reach a variety of individuals not previously included under the fiduciary duty theory.

Penalties for Insider Trading

Penalties for trading on or communicating material non-public information are severe, both for individuals involved in such unlawful conduct and for their employers, and may include fines for the person who committed the violation of up to three times the profit gained or loss avoided, fines for the employer, disgorgement of profits, civil injunctions and even jail sentences.

If you have a relationship with an individual whom you believe is an insider of an issuer (other than a relationship in which you are acting as an analyst on behalf of your employer), you should exercise particular caution so that you do not inadvertently receive material inside information. One way to accomplish this is to tell the individual with whom you have the relationship that he or she should not disclose to you any material information that he or she has not previously disclosed to analysts generally or that the issuer has not otherwise made public.

Establish an Effective Compliance Program

Due to the potential penalties and reputational risk to a business, it is essential for companies and their employees to be mindful of insider trading laws. Employees need to be periodically reminded of their company's policies and procedures regarding material non-public information and personal trading.

Further, companies need to have in place an effective compliance program to prevent and detect insider trading. The SEC and other self-regulatory organizations have sophisticated electronic systems to detect potential instances of insider trading. Prosecutors can use wiretaps in their insider trading investigations.

Make certain your firm has in place clear and precise policies and procedures to prevent insider trading. These policies and procedures should address, among other things, limiting access to material non-public information, not spreading or acting on the basis of rumors, refraining from communicating material non-public information outside the firm, refraining from discussing material non-public information in public places and establishing clear steps to be taken if an employee believes he or she has come into possession of non-public information.

Conclusion

Defending an insider trading case can take a significant amount of time and be quite costly. Even if a person is eventually cleared of any wrongdoing, an investigation itself can have serious detrimental effects on the individual and the company.

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