Insider Trading and the United States Securities Laws

The US Government has sent a clear message that the prosecution of insider trading is a top priority for both the Department of Justice and the Securities and Exchange Commission. With a new weapon in the form of the Sarbanes-Oxley Act, the fight by prosecutors against insider trading has been eased.

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What is 'Insider Trading'?

Insider trading is not a term defined under any of the federal securities laws and can involve both legal and illegal conduct. The legal version is when corporate insiders buy and sell stock in their own companies, and do so within the confines of company policy and applicable law, without breaching any duty owed to the company. The illegal version is the focus of this article.

Although grounded in the Securities Exchange Act of 1934, as amended (the 'Exchange Act'), the term 'insider trading' and its meaning has developed primarily through civil settlements with the Securities and Exchange Commission (SEC) and through judicial case law, both civil and criminal. Two sections of the Exchange Act are relied upon in prosecutions of alleged insider trading: section 10(b), the principal federal securities anti-fraud statutory provision, including rule 10b-5 adopted by the SEC thereunder; and section 14(e), including rule 14e-3 adopted by the SEC thereunder, which specifically prohibits insider trading in the limited context of tender offers. In addition, the Sarbanes-Oxley Act of 2002 (SOX) gave prosecutors a new weapon in fighting insider trading. Section 807[1] of the SOX makes it unlawful to: (1) defraud any person in connection with any security registered under section 12 of the Exchange Act or with respect to which reports are required to be filed under section 15(d) of the Exchange Act; or (2) fraudulently obtain anything of value in connection with the purchase or sale of any such security.

Among other things, rule 10b-5 of the Exchange Act makes unlawful 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. As interpreted over the years by the SEC and the courts, rule 10b-5's provisions have been applied to prevent corporate 'insiders' from trading on non-public or secret information that is 'material', and which is taken from their company in violation of the trust and confidence owed by the insider to the company and its shareholders. This is generally considered to be the 'classic' theory of prohibited insider trading.[2]

Simply stated, insider trading is trading securities while in possession of material non-public information 'in breach of a duty'.

Who is an Insider?

Clearly, the term 'insider' includes officers, directors and employees of the company that issued the securities being traded (the 'Issuer'). Insiders also include those who arguably have a fiduciary relationship with the Issuer, which gives them access to material non-public information, such as bankers, auditors and counsel. These 'temporary insiders' are prohibited from trading on inside information. An 'insider' can also include securities analysts, brokers and shareholders if they come in possession of material non-public information from the company's insiders.

What Constitutes 'Material Non-public Information'?

As to 'materiality', information is material if there is a substantial likelihood that a reasonable investor would consider the information important in making his or her investment decisions. Essentially, material information is news that could reasonably be expected to affect a company's stock price – for better or worse – or the value of other securities issued by a company or other legal entity, such as debt instruments or derivative securities.

Some examples include earnings results (especially if different from the expected) and other financial or operational information, increases or decreases in dividends, acquisitions or dispositions of significant assets, including mergers or joint ventures, major litigation and government investigations or administrative proceedings, significant buy or sell orders by insiders or others who may possess inside information, and the list goes on.

When Does Non-public Information Become Public?

Information becomes public when it has been released by an Issuer or other person or authority and has been sufficiently disseminated broadly to investors in the marketplace, such as a press release being carried or published by *The Wall Street Journal*, Bloomberg Financial, Reuters, etc. Company filings with the SEC and website postings are also recognised means of dissemination of material non-public information.

Securities practitioners once considered, as a general rule of thumb, a period of 48 hours to be an acceptable period for information to become broadly disseminated. Cable news, the internet and internet forums, blogs and other means of electronic communication, including Twitter, can now make material information public in minutes rather than hours.

The 'Misappropriation' Theory

After some legal setbacks in the prosecutions of alleged insider trading, the SEC succeeded in *United States v O'Hagan*[3], in persuading the Supreme Court to extend the boundaries of fiduciary duties under a theory that the person trading 'misappropriated' the material information. This occurs when the person trading on material non-public information 'misappropriated' the information in breach of a duty owed to the source of the information. Following its *O'Hagan* success, the SEC in 2000 adopted rule 10b5-2 under the Exchange Act, which provides a non-exclusive definition of circumstances in which a person trading has a duty of trust or confidence to the Issuer whose securities are being traded.

Under this rule, this duty of trust or confidence exists whenever a person agrees, expressly or implicitly, to maintain information in confidence. However, the recent SEC attempt to prove insider trading against Mark Cuban, a prominent investor and sports team owner, ran into a roadblock in

the federal district court, in the Northern District of Texas, when the court held on 17 July 2009 that liability under the misappropriation theory requires more than breaching an agreement to keep information confidential – it also requires trading in violation of an agreement not to trade on that information.[4] However, on 21 September 2010, the Fifth Circuit Court of Appeals reversed the holding of the lower court and reinstated the SEC's insider trading charges against Cuban, remanding the case to allow the SEC an opportunity to fully develop the factual record through discovery.[5]

The misappropriation theory set forth in rule 10b5-2 also applies whenever the person communicating the material non-public information (the 'tipper') and the person to whom it is communicated (the 'tippee') have such a history or practice of sharing confidences that the recipient knows or reasonably should know that the person providing the information expects the recipient to maintain its confidentiality. Also, and not surprisingly, rule 10b5-2 covers the situation where a person received material non-public information from his or her spouse, parent, child or sibling.

'Tipper' or 'Tippee'

Under either the classical theory first discussed above or under the more recent misappropriation theory, the law holds both the 'tipper' and the 'tippee' equally liable provided the tippee has knowledge, or reasonably should have known, that the tipper was breaching a duty not to disclose the inside information. A tipper does not have to trade or make any profit to incur liability. A tipper can be liable for insider trading even if he or she makes no trade, earns no profit and avoids no losses.

A recent example comes out of the continuing prosecution of prominent hedge fund manager Raj Rajaratnam and others involved with the alleged violations in connection with the Galleon Group. One of the 14 (out of 22 charged) who already have entered a guilty plea is Robert Moffat, a former senior executive at IBM. As reported in the news, Moffat was a tipper who never traded, received no profits, and avoided no losses. Yet he pled guilty to securities fraud and conspiracy in March 2010, and on 13 September 2010 was sentenced to six months in prison and fined US$50,000.

'Pillow talk' can lead to insider trading problems. An ex-Oracle vice president, Christopher Balkenhol, used information obtained from his wife, an assistant to Oracle CEO Larry Ellison, to buy and sell stock in companies that Oracle was planning to purchase. Without admitting any wrongdoing, he settled, returning profits of more than US$97,000 and paying an additional US$100,000 in fines and interest.

Another case involved an Amgen vice-president, who told her husband about positive results with a cancer drug jointly developed with Abgenix and that Amgen might buy that company. She apparently told her husband not to buy the stock, but he did anyway and got caught.

The Martha Stewart case illustrates that inside information need not come from an insider, since it was her broker at Merrill Lynch, Doug Faneuil, who called her with information that ImClone CEO, Sam Waksal, and his family were dumping ImClone stock. Stewart, a successful business woman and prominent media personality, with her own highly rated television program, returned Faneuil's call from her private jet, which was en route to Mexico. At the end of the two-minute call, she instructed him to sell all US$228,000 of her ImClone shares at approximately US$58 per share. When the FDA notified ImClone that its cancer drug application was being denied, ImClone's stock tanked and Stewart ended up in jail.

In addition to potential criminal prosecution, a tipper, although not profiting himself or herself, may still face a civil penalty based on all of the profits made downstream by the tippees. For example, in *SEC v Jones*,[6] a defendant was an insider who tipped his brother about a pending takeover. The brother then tipped others and traded himself. Jones consented to settle the SEC's charges by agreeing to disgorge US$20,000 in trading profits made by the tippees although Jones did not trade himself. He also agreed to pay a civil fine of about US$80,000.

The New Misrepresentation Theory

The SEC last year won a case[7] against a defendant who hacked into a third party's computer system by affirmatively misrepresenting himself in order to gain access to material non-public information, which he then used to trade. The defendant allegedly hacked into a secure server of Thompson Financial Services and gained access to an unreleased earnings report about a public company. The Second Circuit Court of Appeals rejected the defendant's argument that an affirmative duty must exist between the hacker and the source of the information. Instead, the appellate court distinguished the situation where "silence is fraudulent only if there is a duty to disclose,"[8] holding that an affirmative misrepresentation did not require such a duty to exist. This new 'misrepresentation theory', if followed by other courts, could be helpful to the SEC in bringing insider trading cases involving storage of electronic information on computer systems.

Severe Penalties for Insider Trading

Individuals convicted of criminal insider trading can face up to 20 years' imprisonment per violation, criminal forfeiture and fines up to US$5 million or twice the gain from the offence, whichever is greater. In a civil action by the SEC, the penalty could be disgorgement of profits and the greater of US$1 million or three times the amount of the profit gained or loss avoided. Additionally, the SEC can bar the person from serving as an officer or director of a public company.

Civil law suits by investors (contemporaneous traders) can also be brought under section 20A of the Exchange Act against anyone trading while in possession of insider information. However, most private actions are still brought under an implied right of action for violation of rule 10b-5.

In 2009, according to a survey by a prominent international law firm, the SEC filed 35 new insider trading actions and the US Department of Justice (DOJ) brought criminal charges involving insider trading against 31 people. In addition, the DOJ and the SEC have reported that there are numerous open investigations, as has been evidenced by actions brought thus far in 2010.

More than one-third of the cases brought by the SEC, in 2009, involved three or more defendants, and nine of the SEC's cases alleged illegal profits or losses avoided of US$4 million or more. Significantly, eight of the large SEC cases involved an investment professional in some way, and more than half of these eight cases involved hedge funds. George Canellos, the SEC's current Northeast regional director, was reported by Andrew Ross Sorkin of *The New York Times*, in early January 2010, as having cautioned that: "[i]nvestment management, and especially hedge funds, is a big area of emphasis." A report in the 2 December 2009 edition of *The Wall Street Journal* noted that in the prior two months alone, the SEC issued more than three dozen subpoenas to various hedge funds.

In May 2010, according to news reports, Pequot Capital Management and its CEO, Arthur Samberg, agreed to pay nearly US$28 million, consisting of nearly US$18 million in disgorgement of trading profits and interest, and US$10 million in penalties, in order to settle SEC charges of insider trading.

The Galleon Management Case

The Galleon Management criminal prosecution involves allegations of widespread insider trading at several hedge funds, including Galleon Management LP controlled by Raj Rajaratnam, New Castle Funds LLC, Spherix Capital LLC and S2 Capital Management, LP. The DOJ has charged more than 20 individuals in this case and more than half of them have pleaded guilty. The SEC has charged more than 26 defendants in related civil proceedings; both the DOJ and the SEC report that their investigations are ongoing. Cooperating witnesses include: Roomy Kahn; Ali Far and Richard Choo Bang Lee of Spherix Capital; Ali Kumar, formerly a McKinsey director; Gautham Shankar of the Shottenfeld Group; Rajiv Goel, formerly of Intel Capital; and a number of others.

Mark Kurland, a former partner at New Castle Funds, was sentenced on 23 May 2010, to more than two years in prison and forfeiture of US$900,000 in proceeds from the alleged insider trading scheme, becoming the first person to be sentenced in the Galleon related cases. He traded on tips that Danielle Chiesi, a former consultant at New Castle Funds, allegedly received from Robert Moffat, the ex-IBM executive mentioned earlier, and others. Anil Kumar agreed to pay US$2.8 million to settle civil charges filed by the SEC. He admitted passing on confidential information about clients to Raj Rajaratnam and on 7 January 2010, he pleaded guilty to criminal fraud charges and is awaiting sentencing.

Raj Rajaratnam and Danielle Chiesi both entered not guilty pleas in the criminal case and are fighting the SEC civil charges.

Furthermore, wiretaps obtained by federal prosecutors in the Galleon investigation have led to the recent arrest of Don Chu, a consulting-firm executive. This is the first arrest in a new insider trader case which, according to some commentators, may be even larger than the Galleon prosecutions. Chu allegedly provided private information about a company's corporate earnings to a hedge fund.

Tender Offers and Insider Trading

As noted earlier, section 14(e) of the Exchange Act and rule 14e-3 thereunder specifically prohibits insider trading in the limited context of tender offers. Prohibited is the purchase or sale of a security by any person with material information about a tender offer that he or she knows or has reason to know is non-public and which has been acquired directly or indirectly from the tender offerer, the target, or any person acting on their behalf, unless the information and its source have been publicly disclosed, with ample time for market reaction before the trade. Thus, the tender offer provision attaches liability to the person trading even if there is no pre-existing relationship of trust and confidence. In other words, any person and not just insiders can be charged with a violation of section 14(e) and rule 14e-3.

Conclusion

The US Government has sent a clear message that prosecution of insider trading is and will continue to be a top priority for both the DOJ in criminal prosecutions and the SEC in its civil enforcement cases. It is imperative that all businesses which have issued securities that are publicly traded or which are in the financial services business, including brokers, banks and hedge funds, as well as accounting, law and similar service businesses, have and follow established, written and clear policies which prohibit insider trading.

Notes:

1. 18 USC § 1348.
2. See *Chiarella v United States*, 445 US 222 (1980). In *Dirks v SEC*, 463 US 646, 653 (1983), the Supreme Court reiterated that insider trading requires 'the existence of a fiduciary relationship'.
3. 521 US 642 (1997).
4. 634 F Supp 2d 713 (ND Tex 2009).
5. *SEC v Cuban*, 2010 WL3633059, No 09-10996.
6. Civil Action No CV-09-4895 (ND CA filed 15 October 2009).
7. *SEC v Dorozhko*, 574 F 3d 42 (2d Cir 2009).
8. *Id* at 50.