Insider trading has captured the popular imagination. From press accounts, it would seem the most contemptible of corporate behaviors. Remarkably, state corporate law mostly accepts the principle of unfettered share liquidity and only narrowly regulates the trading of company stock by insiders. The real law of insider trading is federal—an offshoot of Rule 10b-5 under the Securities Exchange Act of 1934. See Chapter 22.

This chapter describes the nature of insider trading (§23.1), state corporate law of insider trading (§23.2), the federal “abstain or disclose” duties and enforcement under Rule 10b-5 (§23.3), and new rules on insider trading added by the Sarbanes-Oxley Act of 2002 and revised in the Dodd-Frank Act of 2010 (§23.4). Chapter 24 considers §16 of the Exchange Act, a remedial scheme applicable to short-swing trading profits by designated insiders.

§23.1 INSIDER TRADING—A PRIMER

§23.1.1 Classic Insider Trading

The paradigm case of insider trading arises when a corporate insider trades (buys or sells) shares of his corporation using material, nonpublic
information obtained through the insider’s corporate position. The insider exploits his informational advantage (a corporate asset) at the expense of the corporation’s shareholders or others who deal in the corporation’s stock.

The insider can exploit his advantage whether undisclosed information is good or bad. If good news, the insider can profit by buying stock from shareholders before the price rises on the favorable public disclosure. (An insider can garner an even greater profit on a smaller investment by purchasing “call options” on an options market that give him a right to buy the shares at a fixed price in the future.) If bad news, the insider can profit by selling to unknowing investors before the price falls on unfavorable disclosure. (An insider who does not own shares can also profit by borrowing shares and selling them for delivery in a few days when the price falls, known as “selling short,” or by purchasing “put options,” which give him the right to sell the shares at a fixed price in the future.)

§23.1.2 Misappropriation of Information — Outsider Trading

An insider can also exploit an informational advantage by trading in other companies’ stock — “outsider trading.” If the insider learns that his company will do something that affects the value of another company’s stock, trading on this material, nonpublic information can also be profitable. The insider “misappropriates” this information at the expense of his firm. Although he trades with shareholders of the other company, he violates a confidence of his firm.

Many cases reported in the media as “insider trading” are actually cases of outsider trading on misappropriated information. Although classic insider trading and misappropriation often are grouped together under the rubric of “insider trading,” it is useful to distinguish the two. The justifications for regulating each differ.

§23.1.3 Theories for Regulating Insider Trading

There are a number of theories for regulating trading by those with material, nonpublic information — whether insiders or outsiders.
### Enhance fairness
Insider trading is unfair to those who trade without access to the same information available to insiders and others “in the know” — a fairness rationale. The legislative history of the Exchange Act, for example, is replete with congressional concern about “abuses” in trading by insiders. This fairness notion, however, has not been generally accepted by state corporate law, which has steadfastly refused to infer a duty of candor by corporate insiders to shareholders in anonymous trading markets. See *Goodwin v. Agassiz*, 186 N.E. 659 (Mass. 1933) (rejecting duty of insiders to shareholders except in face-to-face dealings). Moreover, a fiduciary-fairness rationale cannot explain regulation of outsider trading based on misappropriated information.

### Preserve market integrity
Insider trading undermines the integrity of stock trading markets, making investors leery of putting their money into a market in which they can be exploited — a market integrity rationale. A fair and informed securities trading market, essential to raising capital, was the purpose of the Exchange Act. Moreover, market intermediaries (such as stock exchange specialists or over-the-counter market makers) may increase the spread between their bid and ask prices if they fear being victimized by insider traders. Greater spreads increase trading costs and undermine market confidence. Yet a market integrity explanation may overstate the case for insider trading regulation. Many professional participants in the securities markets already trade on superior information; the efficient capital market hypothesis posits that stock prices will reflect this better-informed trading. See §1.2.

### Reduce cost of capital
Insider trading leads investors to discount the stock prices of companies (individually or generally) where insider trading is permitted, thus making it more expensive for these companies to raise capital — a cost of capital rationale. In stock markets outside the United States, studies show that cost of equity decreases when the market introduces and enforces insider trading prohibitions. For this reason, most U.S. public companies have insider trading policies that permit insiders to buy or sell company stock only during “trading windows” — usually 7 to 30 days after important company announcements.

### Protect property rights
Insider trading exploits confidential information of great value to its holder — a business property rationale. Those who trade on confidential information reap profits without paying for their gain and undermine incentives to engage in commercial activities that depend on confidentiality. Although in the information age a property rationale makes sense, theories of liability, enforcement, and private damages have grown in the United States out of the rhetoric of fiduciary fairness and market integrity.
Policing Insider Trading

Insider trading, cloaked as it is in secrecy, is difficult to track down. The stock exchanges have elaborate, much-used surveillance systems to alert officials if trading in a company’s stock moves outside of preset ranges. When unusual trading patterns show up or trading occurs before major corporate announcements, exchange officials can ask brokerage firms to turn over records of who traded at any given time. The exchanges conduct computer cross-checks to spot “clusters” of trading—such as from a particular city or brokerage firm. An Automated Search and Match system, with data on thousands of companies and executives on such things as social affiliations and even college ties, assists the exchanges. If the exchanges see something suspicious, they turn the data over to the SEC for a formal investigation. The SEC can subpoena phone records and take depositions, and promise immunity to informants.

§23.2 STATE LAW ON INSIDER TRADING

In a relatively narrow range of cases, state law limits insiders’ liquidity rights when they trade on material, nonpublic corporate information.

§23.2.1 Fraud or Deceit — Limited Tort Liability

The traditional law of deceit applies when

- The insider affirmatively misrepresents a material fact or omits a material fact that makes his statement misleading. (There is a duty to speak only in a relationship of trust and confidence.)
- The insider knows the statement is false or misleading or, under evolving notions, recklessly disregards its truthfulness.
- The other party actually and justifiably relies on the statement.
- The other party is harmed as a result.

Restatement (Second) of Torts, §§525, 526, 537, 538. Absent a duty to speak, the insider can avoid tort liability by remaining silent. In a public corporation, this is easy. For example, a company insider who knows of an impending special dividend can buy stock on an impersonal trading market. Even if subject to a special duty to speak, the absence of privity dissolves any causal link between the insider’s purchases and particular shareholders’ sales.

Early state courts, on the premise that corporate fiduciaries owe duties to the corporation and not to individual shareholders, regulated insider
§23.2 State Law on Insider Trading

trading only on a showing of actual deceit. This is caveat emptor — the insider has no more duty than a used car salesperson owes her customers.

§23.2.2 State Fiduciary Rules

State corporate law has taken three approaches to insider trading: (1) a duty on insiders not to trade with corporate shareholders in face-to-face transactions while in the possession of highly material, nonpublic corporate information — the “special facts” rule (the majority rule); (2) a duty on insiders not to trade with corporate insiders in face-to-face transactions, regardless of the existence of special facts — the Kansas rule (the minority rule); (3) a duty on insiders to the corporation not to advance their own pecuniary position using corporate information, regardless of the harm to the corporation — the rule in New York.

Special Facts Doctrine

The traditional fraud rule fails to recognize an insider’s fiduciary status. In recognition of this, state courts impose a diluted duty on individual shareholders to disclose their inside information or abstain from trading. In face-to-face transactions — as distinguished from transactions on stock trading markets between anonymous traders — courts have developed a special facts rule under which neither affirmative misrepresentations nor actual reliance need be established.

The special facts doctrine is limited as follows:

- The insider (an officer or director) must have purchased from an existing shareholder — sales by insiders to nonshareholder investors in the case of “bad news” are not covered.
- The insider must be in privity with the selling shareholder — there must be a face-to-face transaction or something approximating it (such as an insider using an agent to hide the insider’s identity).
- The insider must know of highly material corporate information, such as the impending sale of significant corporate assets or the declaration of a special dividend.
- Secrecy is critically important to the sale — it must be clear the shareholder would not have traded had she known the information.

Special facts cases have often involved concealment of the insider’s identity and sympathetic plaintiffs, such as widows.

The special facts rule arose in Strong v. Repide, 213 U.S. 419 (1909). The Supreme Court, applying general federal common law before Erie Railroad v. Tompkins, held a dominant insider could not trade surreptitiously with an
unsuspecting shareholder when the insider possessed highly material, confidential corporate information. Repide (the company’s majority shareholder and general manager) had finished negotiating the sale of a significant corporate property and sought to buy more corporate shares from a fellow shareholder. To hide his identity, Repide used an intermediary who bought the shares from the shareholder’s agent. The Court agreed the agent would not have sold had he known Repide was the buyer. When the contract was finalized, the company’s stock value increased tenfold. The Court held that Repide’s position, along with his active concealment of highly material information, were “special facts” that supported rescission of the stock sale.

**Strict (Kansas) Rule**

A handful of state courts have expanded the special facts rule to impose a duty to disclose material nonpublic information in any face-to-face transaction. “Special facts” need not be present. This stricter approach, which originated in a Kansas case, is known as the “Kansas rule.” In Hotchkiss v. Fischer, 16 P.2d 531 (Kan. 1932), the court said that in direct-negotiated purchases there is a “relation of scrupulous trust and confidence.” A corporate president had told a widow, undecided whether to sell her shares or wait for a dividend, that he was unsure whether a dividend would be declared. The president bought the widow’s shares for $1.25 per share, and a week later the board declared a $1.00 dividend—a possibility of which the president was aware. The court held the president liable. Although the case’s facts fall in the “special facts” mainstream, the “scrupulous trust and confidence” rationale imposes a higher disclose-or-abstain duty. The “Kansas rule” has been rejected in some jurisdictions.

**Limitations of Special Facts and Kansas Rules**

The special facts and Kansas rules have two significant shortcomings. First, the rules assume purchases from existing shareholders on the basis of undisclosed “good news.” A number of courts have refused to impose liability when an insider dumps stock on nonshareholder investors using inside “bad news.” Second, the rules require privity. When insider trading occurs on an anonymous stock trading market, state courts have shown great reluctance to impose a disclose-or-abstain duty.

Consider Goodwin v. Agassiz, 186 N.E. 659 (Mass. 1933), where the court held that insiders who purchased their company’s stock on the Boston Stock Exchange could not be held liable under a special facts test. The insiders had access to a geologist’s theory that, if valid, indicated the possibility of valuable copper deposits on property owned by the company. The court found two problems with imposing liability. First, the insiders had a fiduciary duty to
§23.2 State Law on Insider Trading

the corporation, not to individual shareholders. Assuming the insider trading
did not harm the company, the insiders were not liable as fiduciaries. Second,
privity between buyer and seller does not exist in anonymous trading on a
stock exchange. There would be insurmountable practical problems of mak-
ing disclosure to other traders, deciding when information (such as a geolo-
gist’s theory) becomes material, and aligning sale and purchase transactions
to determine which shareholders are entitled to recover and how much.

§23.2.3 Liability to Corporation

In an attempt to overcome these gaps in the common law, the New York Court
of Appeals held more than 30 years ago that insider trading creates liability
to the corporation, which liability can be enforced in a derivative suit. Diamond v.
Oreamuno, 248 N.E.2d 910 (N.Y. 1969). The case involved insiders who had
dumped their stock after learning nonpublic bad news about the company’s
earnings. To the objection that the corporation had not been harmed, the
court had two responses. First, it held no harm need be shown. As between
the insiders and the corporation — just as when an agent receives confiden-
tial information on behalf of his principal — the corporation “has a higher
claim to the proceeds derived from the exploitation of the information.” The
insider cannot unjustly enrich himself. Second, the court inferred that the
insider trading might have damaged the corporation’s reputation and thus
the marketability of its stock — though this need not be proved.

The Diamond v. Oreamuno court analogized its novel approach to §16(b) of
the Exchange Act, which allows the corporation in a direct or derivative suit
to recover short-swing trading profits from designated insiders (see §24.3).
The court, however, pointed out the inadequacy of federal remedies. In the
case, §16(b) offered no relief because trading had occurred outside the
provision’s six-month window. According to the court, Rule 10b-5 raised
unresolved issues on the class entitled to recover, the measure of damages,
and the allocation of recovery. (As we will see, these 10b-5 issues are today
somewhat clearer. See §23.3 below).

The Diamond v. Oreamuno approach has not fared well outside New York.
Some courts have rejected the approach outright. Schein v. Chasen, 313 So. 2d
739 (Fla. 1975). Other courts have said that corporate recovery for insider
trading requires that the corporation “could have used the information to
its own profit.” Freeman v. Decio, 584 F.2d 186 (7th Cir. 1978). For example, if
the corporation was about to repurchase its own stock in the market, insider
purchases would directly compete and raise the price to the corporation.
See Brophy v. Cities Service Co., 70 A.2d 5 (Del. 1949).

In recent years, the Delaware courts have recognized the ability of share-
holders to bring derivative claims on behalf of the corporation (so-called
Brophy claims) when an insider uses material, nonpublic information to
23. Insider Trading

trade in the company’s securities. See In re Oracle Corp. Deriv. Litig., 867 A.2d 904 (Del. Ch. 2004). It is not necessary that the corporation suffered an actual harm; it is enough that the insider was unjustly enriched. The remedy in such cases is disgorgement of the insider’s profits to the corporation. See Kahn v. Kollberg Krovis Roberts & Co., 23 A.3d 831 (Del. 2011) (holding that special litigation committee could not dismiss Brophy claim against insider who acquired company’s preferred shares while in possession of material, nonpublic information).

Although liability to the corporation offers a practical solution to the limits of the traditional insider trading rules, it has some troubling and strange implications. First, shareholders who hold their shares during the insider trading receive a windfall in a corporate recovery. If the insider trading is on good news, the losers are the shareholders who sold their shares at deflated prices. They do not share in the corporate recovery at all. If the insider trading is on bad news, the losers are the investors who bought the stock at inflated prices. They recover only to the extent the corporate recovery increases the value of their stock—at most a partial recovery. Second, corporate recovery also creates the possibility of double liability. Besides being liable to the corporation, the insiders may be liable under Rule 10b-5 to contemporaneous traders (see §23.3.4). Although the Diamond v. Oreamuno court suggested this problem could be handled by interpleader, there will be jurisdictional, notification, and class certification difficulties.

Despite these deficiencies, the ALI Corporate Governance Principles adopted an unjust-enrichment approach similar to Diamond v. Oreamuno and the Delaware cases accepting Brophy claims, with the additional gloss that the corporation (or the shareholders as a group) can authorize or ratify insider trading if in the corporation’s interest. ALI Principles §5.04 (prohibiting insiders from using material nonpublic information concerning the corporation to advance their pecuniary interests, whether or not this use harms the corporation). The ALI Principles views a rule of corporate recovery as better than no rule at all.

Outsider Trading under State Law

You may have noticed that, until now, we have talked only about insiders trading in their company’s shares—classic insider trading. Very few state cases involve allegations of trading in other companies’ shares using “misappropriated” information—outsider trading. At most, outsider trading may violate state trade secret laws and the antifraud provisions of state “blue sky” laws. See §5.1.3.

Examples

1. Elbert, a chemist of ITM Corp., has conducted tests on a cost-effective electrolysis process (separation of water into hydrogen and oxygen)
§23.2 State Law on Insider Trading

using a cobalt/phosphate film at room temperatures. The results are a huge scientific breakthrough with enormous commercial potential. Daniela, ITM’s president, learns of the tests and sends a memo to all who know of them urging complete secrecy. ITM’s stock, which is publicly traded, doubles when ITM eventually confirms the tests and discloses the discovery. Assume the following happen before public disclosure—

a. After Elbert’s tests are confirmed, ITM’s board offers Daniela options on the company’s stock. Daniela accepts the options without telling the board of Elbert’s tests. Is Daniela liable to the corporation under state law?

b. Before Elbert’s tests are confirmed, Daniela purchases ITM stock from Columbia Employees Pension Trust, one of ITM’s major institutional shareholders. Daniela buys the stock from CEPT using a stockbroker, who does not disclose for whom the purchases are made. Is Daniela liable to CEPT?

c. Daniela purchases ITM stock through her broker, who fills the order on a stock exchange. Shareholders who sold at about the time of Daniela’s purchases seek to recover from her the profits they would have made if they had not sold. Can they under state common law?

d. Elbert (who is neither a director nor officer of ITM) purchases ITM stock from fellow employees who do not know of the discovery. He says nothing to them, and they do not ask. Is Elbert liable to these shareholders under state common law?

2. Let’s turn the tables. Assume ITM publicly announces Elbert’s tests before they are confirmed. The price of ITM’s stock rises dramatically. Elbert then tells Daniela the announcement was premature. The tests appear to have been a fluke and cannot be reproduced. When ITM issues a public disclaimer, the price of its stock plummets to preannouncement levels. Assume the following happen before ITM disavows the original announcement—

a. Daniela sells her stock under a corporate stock repurchase program at current market prices. She does not tell the board or anyone else that the announcement has become misleading. Is Daniela liable to the corporation under state law?

b. Daniela sells her entire shareholding to Mutual of Columbia, a major insurance company, through various brokers who do not disclose for whom they were selling. Is Daniela liable to MOC under state common law?

c. Elbert (who is neither a director nor officer of ITM) buys put options as soon as he realizes the original tests are flukes. Can any of those on the other side of these transactions recover under state common law?

d. Elbert prepares the original announcement about the cobalt/phosphate electrolysis process, knowing that his preliminary tests are
flukes. Elbert buys options, as above. Is he liable to the parties on the other side of these transactions under state common law?

**Explanations**

1. a. Probably, under both state fraud law and common law of insider trading. As the company’s CEO, Daniela has a fiduciary duty to the corporation not to use her position to harm the corporation. Although she did not misrepresent anything, deceit law imposes a duty to speak on those in a relationship of trust and confidence. Further, her silence in the face-to-face negotiations fits the “special facts” test. The discovery had enormous potential value, and it is likely the board would have reconsidered its decision to approve the options.

b. Perhaps under the strict Kansas rule. CEPT probably will be unable to show all the elements of fraud — there were no affirmative misrepresentations and CEPT did not actually rely on Daniela’s silence. CEPT did not know it was buying from Daniela and thought it was selling at a good price. Although evolving fraud standards impose a duty to disclose in a confidential relationship — requiring disclosure to an employer or a client — state fraud law has not yet expanded to cover a corporate insider’s relationship to shareholders.

Both the strict Kansas rule and the more limited “special facts” doctrine cover insiders’ trading outside of impersonal trading markets. Nonetheless, the “materiality” requirements under the tests are different. Under the “special facts” doctrine, Elbert’s preliminary tests must have constituted unusual or extraordinary information that, if disclosed, would have caused a reasonable shareholder to have acted differently. This may be hard to show because the tests had to be confirmed, and a reasonable shareholder might have viewed the preliminary tests as flukes. The strict Kansas rule is less deferential. It is enough that the information would have been important to the shareholder’s decision to sell. In view of the enormous potential revealed by the preliminary tests, Daniela’s duty of “scrupulous trust and confidence” probably would have required her not to trade without first disclosing the tests and their potential implications.

c. No. State fraud law requires some misrepresentation, absent in this case of impersonal market trading. Moreover, identifiable privity is required under the “special facts” doctrine and the strict Kansas rule. The absence of face-to-face dealings will preclude these shareholders from recovering from Daniela. Notice that the *Diamond v. Oreamuno* corporate recovery approach also leaves them in the cold because any recovery goes only to the corporation.

d. No. Although state fraud law prohibits silence by those in a confidential relationship, it is unlikely that Elbert’s coworker relationship would
be enough. Courts have applied the special facts and strict Kansas rules
only to officers and directors. Thus, even though Elbert as an employee
has a fiduciary relationship to the corporation, he may not have a
corporate fiduciary relationship to fellow coworkers or shareholders
under state law.

2. a. Probably. Just as a fiduciary cannot buy from the corporation on the
basis of undisclosed “good news,” the fiduciary cannot sell to the cor-
poration on the basis of undisclosed “bad news.” Elbert’s inability to
confirm the original tests would seem to be material under both a
special facts and Kansas rule.

b. No. There was no affirmative misrepresentation or confidential rela-
tionship, and hence no fraud under state law. Further, liability under
a special facts or strict Kansas rule is premised on the fiduciary’s
relationship to existing shareholders. Daniela’s sale to a nonshare-
holder investor leaves MOC unprotected under traditional state law.
Even if corporate recovery were available under a Diamond v. Oreamuno
theory, ITM’s recovery would only indirectly and partially compen-
sate MOC to the extent the recovery increased the value of MOC’s
shares.

c. Probably not. Under a put option, Elbert receives a contractual right
to sell ITM stock to the option sellers in the future at a predetermined
price (the strike price). If the strike price is higher than the market price
on the strike date—which will certainly be the case once the “bad
news” is announced—Elbert will profit either by selling cheap stock
or (as is more common) by simply having the other party buy back
the commitment at the difference between the lower market price
and the higher strike price. There are options markets on which these
arrangements can be made.

There are a number of impediments for options sellers to recover.
Fraud law requires some affirmative misrepresentation—there was
none. Corporate fiduciary rules require that there have been some
semblance of privity—there was none. Further, because options trad-
ers are not shareholders of the corporation, even Diamond v. Oreamuno
recovery may be unavailable since the disappointed traders were not
past or present shareholders.

d. Yes, under a fraud theory. Fraud law does not require privity; it is
enough that Elbert knowingly made an affirmative misrepresentation
intending that others rely, that the options sellers actually and justifiably
relied, and that they were damaged as a result. Assuming the options
sellers knew of the ITM announcement—which is likely—they have
a good chance to recover. State corporate law, however, provides little
help. None of the options sellers was trading in the capacity of an ITM
shareholder.
§23.3 APPLICATION OF RULE 10B-5 TO INSIDER TRADING

Federal securities regulation of insider trading has developed in stages. It began with the novel scheme in the Exchange Act for the disgorgement of insider trading profits, a scheme aimed at discouraging stock price manipulation by corporate insiders (see Chapter 24). Later in the 1960s the SEC and federal courts used Rule 10b-5 to build an awkward “abstain or disclose” jurisprudence applicable to insiders who trade on material, nonpublic, confidential information. See In re Cady, Roberts & Co., 40 SEC 907 (1961) (first case suggesting that trading on inside information might violate Rule 10b-5). In the 1980s Congress entered the fray and increased the penalties for insider trading, clarified the scope and mechanisms for private enforcement, and imposed additional surveillance duties on firms with access to inside information. In 2000 the SEC promulgated rules clarifying the state of mind that triggers liability and the persons who become subject to the “abstain or disclose” duty. In 2002 Congress sought to discourage insider trading by executives that came at the expense of employees or was based on falsified company financials. In 2010 Congress strengthened corporate “clawback” devices to discourage corporate executives from manipulating company financials to increase their stock-based pay.

The development of 10b-5 insider trading duties is a fascinating story of judicial activism and ingenuity in the face of a statutory lacuna. It also offers an insight into the operation of corporate federalism. Perceiving a failure by state corporate law to regulate insider trading, federal courts have used Rule 10b-5 to develop a theory of disclosure-based regulation that assumes the existence of fiduciary duties of confidentiality that state courts have been unwilling to infer.

§23.3.1 Federal Duty to “Abstain or Disclose”

Federal courts have interpreted Rule 10b-5 to prohibit securities fraud. See §22.1. No person may misrepresent material facts that are likely to affect others’ trading decisions. This duty is meaningless to insider trading, which happens not by means of misrepresentations but rather silence. Over time, federal courts have developed rules against insider trading based on implied fiduciary duties of confidentiality.

Parity of Information

Early federal courts held that just as every securities trader is duty-bound not to lie about material facts, anyone “in possession of material, nonpublic
Section 23.3 Application of Rule 10b-5 to Insider Trading

Information must either abstain from trading or disclose to the investing public—a duty to abstain or disclose. See SEC v. Texas Gulf Sulphur, 401 F.2d 833 (2d Cir. 1968). But even the proponents of a “parity of information” (or “equal access”) approach recognized that an absolute rule against trading when one has an informational advantage goes too far. Strategic silence is different from outright lying. To impose an abstain-or-disclose duty on everyone with material, nonpublic information—however obtained—would significantly dampen the enthusiasm for trading in the stock market. Capital formation might dry up if investors in trading markets were prohibited from exploiting their hard work, superior skill, acumen, or even their hunches. Investors would have little incentive to buy securities if they could not resell them using perceived informational advantages.

Fiduciary Duty of Confidentiality

In the early 1980s the Supreme Court provided a framework for the abstain-or-disclose duty. Chiarella v. United States, 445 U.S. 222 (1980); Dirks v. SEC, 463 U.S. 646 (1983). A decade later the Court brought “outsider trading” within this framework. United States v. O’Hagan, 521 U.S. 642 (1997). Reading Rule 10b-5 as an antifraud rule, the Court has held that any person in the possession of material, nonpublic information has a duty to disclose the information, or abstain from trading, if the person obtains the information in a relation of trust and confidence—a fiduciary relation. The Supreme Court thus anchors federal regulation of classic insider trading on a presumed fiduciary duty of corporate insiders to the corporation’s shareholders—even though state corporate law has largely refused to infer such a duty in impersonal trading markets. See §23.2.2. Thus, the federal regulation of insider trading began largely as a judicial invention! The Court has extended this fiduciary-based regulation to cover trading by outsiders who breach fiduciary duty of confidentiality to persons or entities unrelated to the corporation in whose securities they trade.

Chiarella v. United States (classic insider trading)

Chiarella was employed in the composing room of a financial printer. Using his access to confidential takeover documents that his firm printed for corporate raiders, he figured out the identity of certain takeover targets. Chiarella then bought stock in the targets, contrary to explicit advisories by his employer. He later sold at a profit when the raiders announced their bids. The Supreme Court reversed Chiarella’s criminal conviction under Rule 10b-5 and held that Rule 10b-5 did not impose a “parity of information” requirement. Merely trading on the basis of nonpublic material information, the Court held, could not trigger a duty to disclose or abstain. Chiarella had no duty to the shareholders with whom he traded because he had no
23. Insider Trading

The fiduciary relationship to the target companies or their shareholders. (The Court decided that Chiarella could not be convicted for trading on information misappropriated from his employer since the theory was not presented to the jury.)

**Dirks v. SEC (tipper-tippee)**

Dirks was a securities analyst whose job was to follow the insurance industry. When he learned of an insurance company’s massive fraud and imminent financial collapse from Secrist, a former company insider, Dirks passed on the information to his firm’s clients. They dumped their holdings before the scandal became public. On appeal from SEC disciplinary sanctions for Dirks’s tipping of confidential information, the Supreme Court held that Dirks did not violate Rule 10b-5 because Secrist’s reasons for revealing the scandal to Dirks were not to obtain an advantage for himself. For Secrist to have tipped improperly “in connection with” the trading by Dirks’s clients, the Court held, there had to have been a fiduciary breach. The Court took the view that a breach occurs when the insider gains some direct or indirect personal gain or a reputational benefit that can be cashed in later. In the case, Secrist had exposed the fraud with no expectation of personal benefit, and Dirks (whose liability depended on Secrist violating a fiduciary duty) could not be liable for passing on the information to his firm’s clients.

**United States v. O’Hagan (misappropriation)**

O’Hagan was a partner in a law firm retained by a company planning to make a tender offer for a target company. He purchased common stock and call options on the target’s stock before the bid. Both the bidder and law firm had taken precautions to protect the bid’s secrecy. When the bid was announced, O’Hagan sold for a profit of more than $4.3 million. After an SEC investigation, the Justice Department brought an indictment against O’Hagan alleging securities fraud, mail fraud, and money laundering. He was convicted on all counts and sentenced to prison. The Eighth Circuit, however, reversed his conviction on the ground misappropriation did not violate Rule 10b-5. (The Eighth Circuit also held the SEC exceeded its authority in promulgating Rule 14e-3. See §23.3.3 below.) The Supreme Court reversed and validated the misappropriation theory. The Court concluded that the unauthorized use of confidential information is (1) the use of a “deceptive device” under §10(b) and (2) “in connection with” securities trading. First, the misappropriator “deceives” the source that entrusted to him the material, nonpublic information by not disclosing his evil intentions—a violation of fiduciary duty. Second, the “fiduciary’s fraud is consummated, not when the fiduciary gains the confidential information, but when … he
§23.3 Application of Rule 10b-5 to Insider Trading

uses the information to purchase or sell securities.” Citing to the legislative history of the Exchange Act and to SEC releases, the Court concluded that misappropriation liability would “insure the maintenance of fair and honest markets [and] thereby promote investor confidence.” O’Hagan’s trading operated as a fraud on the source in connection with securities trading—a violation of Rule 10b-5.

Satisfying the Disclosure Duty

According to the logic of the 10b-5 “abstain or disclose” construct, a fiduciary may trade on confidential information by first disclosing the information to the person to whom she owes the fiduciary duty. See SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968) (suggesting that insiders wait 24 to 48 hours after information is publicly disclosed to give it time to be disseminated through wire services or publication in the financial press). In a similar vein, some companies have internal policies that permit corporate insiders to trade only during a one- or two-week period after the company files quarterly and annual reports. As a practical matter, the abstain-or-disclose duty is really a prohibition against trading, since any disclosure must be effective in eliminating any informational advantage to the person who has material, nonpublic information—thus eliminating any incentive to trade.

State of Mind

An unsettled issue in the cases has been the state of mind that triggers insider trading liability when a person purchases or sells securities. In O’Hagan the Supreme Court said that insider trading must be “on the basis” of material, nonpublic information. Lower courts have split on whether the trader must be in “knowing possession” of inside information or must actually consciously “use” the information in trading. Compare United States v. Teicher, 987 F.2d 112 (2d Cir. 1993) (accepting “knowing possession” standard, as simpler to apply and consistent with the expansive nature of Rule 10b-5, where a young attorney tipped inside information about transactions involving clients of his law firm); United States v. Smith, 155 F.3d 1051 (9th Cir. 1998) (requiring showing of “use” of inside information, particularly when a defendant’s state of mind is at issue in criminal case).

In 2000 the SEC adopted a rule to clarify this aspect of insider trading liability. Rule 10b5-1. Under the rule, a person trades “on the basis” of material, nonpublic information if the trader is “aware” of the information when making the purchase or sale. Rule 10b5-1(b). In its release accompanying the rule, the SEC explained that “aware” is a commonly used English word, implying “conscious knowledge,” with clearer meaning than
23. Insider Trading

“knowing possession.” Does the SEC have rulemaking authority to define the elements of insider trading, which (until now) has been governed exclusively by judge-made rules? Arguably the agency that begot Rule 10b-5 can also change and define its contours.

Preexisting Trading Plans

The SEC has also sought to clarify when corporate insiders and others can trade in company stock even when aware of inside information. Individuals and entities who set up specific securities trading plans when unaware of inside information can avoid liability even if trading under the plan occurs later when they are aware of inside information. Rule 10b5-1(c). The person must demonstrate the following:

- She had entered in “good faith” into a binding contract to trade the security, instructed another person to execute the trade for her account, or adopted a written plan for trading securities—when unaware of inside information.
- This preexisting trading strategy either (1) expressly specified the amount, price, and date of the trade; (2) included a written formula for determining these inputs; or (3) disabled the person from influencing the trades, providing the actual trader was unaware of the inside information.
- The trade accorded with this preexisting strategy.

An entity (nonindividual) has an additional affirmative defense if the actual individual trading for the entity was unaware of inside information and the entity had policies and procedures to ensure its individual traders would not violate insider trading laws. Rule 10b5-1(c)(2).

In 2009 the SEC provided some interpretive guidance when Rule 10b5-2 plans are revised. First, although termination of a trading plan does not automatically trigger 10b-5 liability, a termination that “coincides” with insider trading may violate Rule 10b-5. Second, canceling and then replacing an existing plan may also run into problems if the actions are part of a “scheme to evade” the rule; such liability can be minimized with a “waiting period” between the cancellation and replacement.

§23.3.2 Insider Trading 10b-5 Primer

The linchpin of 10b-5 insider trading liability is the knowing misuse of material, nonpublic information entrusted to a person with duties of confidentiality. Attempting to provide a general definition, the SEC’s Rule 10b5-1 offers a restatement of federal insider trading law:
§23.3 Application of Rule 10b-5 to Insider Trading

The “manipulative and deceptive devices” prohibited by Section 10(b) of the Act and Rule 10b-5 thereunder include, among other things, the purchase or sale of a security of any issuer, on the basis of material, nonpublic information about that security or issuer, in breach of a duty of trust and confidence that is owed directly, indirectly, or derivatively, to the issuer of that security or the shareholders of that issuer, or to any other person who is the source of the material, nonpublic information.

Although the Supreme Court has glossed over the provenance of these duties, its opinions lead to some clear guidance to persons who have material, nonpublic information:

| **Insiders** | Insiders who obtain material, nonpublic information because of their corporate position — directors, officers, employees, and controlling shareholders — have the clearest 10b-5 duty not to trade in the securities of their company. See Chiarella. |
| **Constructive (temporary) insiders** | Constructive insiders who are retained temporarily by the company in whose securities they trade — such as accountants, lawyers, and investment bankers — are viewed as having the same 10b-5 duties as corporate insiders. See Dirks (dictum). Lower courts have also inferred status as constructive insider in family settings where there are expectations of confidentiality. |
| **Outsiders (with duty to source of information)** | Outsiders with no relationship to the company in whose securities they trade also have an abstain-or-disclose duty when aware of material, nonpublic information obtained in a relationship or trust and confidence with the company (or source) of that information. See O'Hagan. The outsider’s breach of confidence to the information source is deemed a deception that occurs “in connection with” his securities trading. |
| **Tippers** | Those with a confidentiality duty — whether an insider or an outsider — who knowingly make improper tips are liable as participants in illegal insider trading. See Dirks. The tip is improper if the tipper expects the tippee will trade and anticipates reciprocal benefits — such as when she sells the tip, gives it to family or friends, or expects the tippee to return the favor. This liability extends to subtippers who know (or should know) a tip is confidential and came from someone who tipped improperly. The tipper or subtipper can be held liable even though she does not trade, so long as a tippee or subtippee down the line eventually does. |

(Continued)
### 23. Insider Trading

<table>
<thead>
<tr>
<th>Tippees</th>
<th>Those without a confidentiality duty inherit a 10b-5 abstain-or-disclose duty if they knowingly trade on improper tips. <em>Dirks.</em> A tippee is liable for trading after obtaining material, nonpublic information that he knows (or has reason to know) came from a person who breached a confidentiality duty — whether an insider or an outsider. In addition, <em>subtippees</em> tipped by a tippee assume a duty not to trade if they know (or should know) the information came from a breach of duty.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Traders in derivative securities</td>
<td>The 10b-5 duty extends to trading with nonshareholders — such as options traders. <em>O’Hagan</em> (call options). The Insider Trading Sanctions Act of 1984 makes it unlawful to trade in any derivative instruments while in possession of material, nonpublic information if trading in the underlying securities is illegal. Exchange Act §20(d).</td>
</tr>
<tr>
<td>Strangers</td>
<td>A stranger with no relationship to the source of material, nonpublic information — whether from an insider or outsider — has no 10b-5 duty to disclose or abstain. <em>Chiarella.</em> Strangers who overhear the information or develop it on their own have no 10b-5 duties.</td>
</tr>
</tbody>
</table>

It is important to notice that corporate insiders (directors, officers, employees, and agents) often own stock in their companies. This is not illegal—in fact, it is sometimes highly desirable for corporate actors to have some “skin in the game.” Nor is it illegal for these insiders to buy and sell their company stock. The only time there is a problem is when these insiders are aware of nonpublic, material information when they trade in their company’s stock or the stock of another company—or improperly tip this information to others.

### §23.3.3 Outsider Trading — Misappropriation Theory

The misappropriation theory is a bit tricky. Under the theory, 10b-5 liability arises when a person trades on confidential information in breach of a duty owed to the source of the information, even if the source is a complete stranger to the traded securities. *United States v. O’Hagan,* 521 U.S. 642 (1997). In effect, the deception is on the source and the trading with another party. This “fraud on the source” construct raises a number of issues: the basis for misappropriation liability, the scope of the duty of confidentiality, and the validity of the SEC’s rule creating misappropriation liability for tender offer information.

Notice the difference between an *outsider* who misappropriates information from a source unrelated to the company in whose securities the outsider trades and a *tippee* who receives information from a fiduciary inside...
§23.3 Application of Rule 10b-5 to Insider Trading

a company in whose securities the tippee (or subtippee) trades. The outsider’s duty is to the “outside” source of the information; the tippee’s duty is derived from the duty to the “insider” who tips improperly.

Misappropriation Theory

The O’Hagan decision was an important victory for the SEC, which ten years before had failed to convince the Supreme Court that Rule 10b-5 encompasses a misappropriation theory. Carpenter v. United States, 484 U.S. 19 (1987) (split 4-4 decision).

Although the ruling in O’Hagan removed any uncertainty about whether Rule 10b-5 regulates securities trading using misappropriated information, it exposed doctrinal rifts in the Court’s 10b-5 jurisprudence. First, O’Hagan suggests that there can be no 10b-5 insider trading liability if there is no breach of trust and confidence. Thus, a person who gains access to material, nonpublic information by other wrongful means—such as outright theft—would seemingly not face 10b-5 sanctions. Moreover, a fiduciary who discloses his trading intentions or receives permission to trade from the information source would escape 10b-5 liability since there would arguably be no breach of his abstain-or-disclose duty. Cf. SEC v. Rocklage, 470 F.3d 1 (1st Cir. 2006) (upholding misappropriation claim against wife who “tricked” husband into revealing confidential company information and then tipped her brother who traded on the information, even though husband asked wife not to tip when she revealed her plans).

Second, O’Hagan leaves largely unanswered the question of who has duties of trust and confidence and when a duty of confidentiality attaches. For lawyer O’Hagan, it was easy to identify his duties to his law firm and thus to the bidder, but the inquiry becomes more difficult when a person overhears a conversation or has only a superficial relationship with the information source. See SEC v. Switzer, 590 F. Supp. 756 (W.D. Okla. 1984) (holding that eavesdropper is not liable for trading after overhearing CEO tell his wife company might be liquidated).

Duty of Confidentiality in Misappropriation Cases

The duty of trust and confidence in misappropriation cases is clearest when confidential information is misappropriated in breach of an established business relationship, such as investment banker—client or employer-employee. The duty is less clear in other business and personal settings.

In an attempt to provide clarity, the SEC has promulgated a rule that specifies when a recipient of material, nonpublic information is deemed to owe a duty of trust and confidence to the source for purposes of misappropriation liability. Rule 10b5-2(b):
• The recipient agreed to maintain the information in confidence.
• The persons involved in the communication have a history, pattern, or practice of sharing confidences (both business and nonbusiness confidences) so the recipient had reason to know the communicator expected the recipient to maintain the information’s confidentiality.
• The communicator of the information was a spouse, parent, child, or sibling of the recipient, unless the recipient could show (based on the facts and circumstances of that family relationship) that there was no reasonable expectation of confidentiality.

Confidentiality expectations outside the family.

By their terms, the rule’s first two categories clarify when confidentiality expectations—and thus a duty of trust or confidence—arise in nonbusiness and business settings outside the family. Thus, a contractual relationship (though not necessarily creating a fiduciary relationship) could give rise to a duty not to use confidential information, if that is what the parties had agreed to or mutually understood. In addition, as the SEC stated in its preliminary note to the rule, the list is not exclusive, and a relationship of trust and confidence among family members or others can be established in other ways, as well.

Are confidentiality expectations, without a legal relationship of trust and confidence, enough to trigger a 10b-5 duty to “disclose or abstain”? That is, did the SEC overstep its rulemaking authority in Rule 10b5-2 by identifying duties of “trust and confidence” in the absence of a fiduciary relationship? Consider the case by the SEC against Mark Cuban, of Audionet and Dallas Mavericks fame. In 2004 Cuban had a phone conversation with the CEO of Mamma.com, a company in which Cuban was a 6.3 percent shareholder, and he learned that Mamma was planning to accept a new investor that would dilute existing shareholders. According to the SEC, Cuban said to the CEO he would keep the information confidential, but then he sold his Mamma shares and avoided losses of $750,000 in the process. When the SEC brought an insider case against him, Cuban argued that his relationship with the Mamma CEO and any confidentiality promise he made did not create a cognizable §10(b) duty. The trial court disagreed with Cuban, but dismissed the SEC’s case on the theory that Cuban’s oral promise of confidentiality encompassed only keeping the information confidential, but did not bar trading. On appeal, the Fifth Circuit did not address the lower court’s novel parsing of Cuban’s confidentiality promise or the validity of Rule 10b5-2, but instead held that the SEC’s complaint laid out a “more than a plausible” case of insider trading, and remanded for further proceedings. SEC v. Cuban, 634 F. Supp.2d 713 (N.D. Tex. 2009), vacated and remanded, 620 F.3d 551 (5th Cir. 2010). So the case continues.
Confidentiality expectations inside the family.

Rule 10b5-2 was adopted largely in response to the anomaly in the case law that a family member who trades on material, nonpublic information obtained from another family member violates Rule 10b-5 if the trading breached an express promise of confidentiality, but a family member does not violate Rule 10b-5 if there was only a reasonable expectation of confidentiality. The SEC rule treats trading by family members on the basis of inside information as undermining market and investor confidence, whether the expectation of confidentiality was express or implied. As the SEC explained, the trader’s informational advantage in either case stems from “contrivance, not luck.” Additionally, the SEC viewed its brighter-line approach as less intrusive than a case-by-case analysis into the nature of family relationships, as required by existing case law. See United States v. Chestman, 947 F.2d 551 (2d Cir.1991) (en banc) (holding that son-in-law owed no duty to in-laws who planned to sell their supermarket chain, when he and his broker traded on confidential information about impending sale).

Some courts have used this “expectation” analysis in cases of classic insider trading on the question whether family members qualify as “constructive insiders.” In SEC v. Yun, 327 F.3d 1263 (11th Cir. 2003), a husband told his wife during divorce discussions that his stock options should be re-valued at a lower price because of a soon-to-be-made announcement of a drop in company earnings. The wife then told office mates about this impending news, who traded on the tip. The court held that spousal communications implicated a fiduciary duty when the communicating spouse has a “reasonable expectation of confidentiality” — given their history or practice of sharing business confidences. The court commented that Rule 10b5-2, which creates a presumption of spousal confidentiality in misappropriation cases, bolstered the conclusion that spouses should be understood to have expectations of confidentiality in cases of classic insider trading.

Tipping of Misappropriated Information

Not only is it illegal to trade on a tip from an insider, it is illegal to trade based on a tip from an outsider who passes on misappropriated information to obtain a personal benefit. That is, 10b-5 tipping liability described in Dirks applies to tips both from insiders and from outsiders. See United States v. Falcone, 257 F.3d 226 (2d. Cir. 2001) (finding 10b-5 liability when distributor of Business Week, before magazine went on sale to general public, passed on copies to neighbor/broker who traded on nonpublic information in magazine).
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Rule 14e-3—Misappropriation of Tender Offer Information

The SEC has used the misappropriation theory to adopt rules prohibiting trading based on material, nonpublic information about unannounced tender offers. Using its rulemaking authority under §14(e) of the Exchange Act—which allows rules aimed at “fraudulent, deceptive, or manipulative acts or practices, in connection with any tender offer”—the SEC prohibited trading by those with inside information about a tender offer. Exchange Act Rule 14e-3. The rule prohibits, during the course of a tender offer, trading by anybody (other than the bidder) who has material, nonpublic information about the offer that he knows (or has reason to know) was obtained from either the bidder or the target. Notice that there is no need under Rule 14e-3 to prove that a tipper breached a fiduciary duty for personal benefit. See United States v. O’Hagan, 521 U.S. 642 (1997) (upholding SEC’s rulemaking authority to “define and prescribe means reasonably designed to prevent [fraudulent] acts” under §14(e) of the Exchange Act).

The Second Circuit has considered the difference between 10b-5 and 14e-3 liability. United States v. Chestman, 947 F.2d 551 (2d Cir. 1991) (en banc). In the case Chestman, a stock broker, learned of an impending tender offer from the husband of the niece of the company’s controlling shareholder. The controlling shareholder had agreed to sell his control block as a prelude to the purchaser’s tender offer. When Chestman traded on this information for himself and his clients, the government prosecuted him under Rules 10b-5 and 14e-3. The Second Circuit affirmed Chestman’s 14e-3 conviction, for which no showing of duty was necessary. But the court held he could not be convicted under a 10b-5 misappropriation theory because the family tipper had no duty to his family to guard confidential information.

Mail and Wire Fraud—Criminal Liability for Misappropriation

Misappropriation of confidential information can also be the basis of non-securities criminal liability. In Carpenter v. United States, 484 U.S. 19 (1987), the Supreme Court had sidestepped the 10b-5 quagmire by affirming in an 8-0 decision a Wall Street Journal reporter’s conviction under federal mail and wire fraud criminal statutes for misappropriating and tipping information before it appeared in a column he wrote. (The SEC cannot enforce the mail and wire fraud statutes, which can only be enforced by the Justice Department in a criminal prosecution.) The Court held that the newspaper had a “property” interest in keeping the column confidential prior to publication, and that the reporter’s breach of his confidentiality obligation defrauded the newspaper. Although the Court’s decision raises disquieting issues about criminal liability for breaching an employment stipulation, the case makes
§23.3 Application of Rule 10b-5 to Insider Trading

clear that trading on misappropriated securities-related information is subject to criminal penalties.

§23.3.4 Remedies for Insider Trading

Insider traders are subject to an imposing host of sanctions and liabilities. As the following list makes clear, it is no wonder that law firms tell new lawyers not to trade on clients’ confidential information.

Civil Liability to Contemporaneous Traders

In an impersonal trading market, it is unclear who is hurt by insider trading and how much. Shareholders and investors who trade at the same time as an insider presumably would have traded even had the insider fulfilled his duty and abstained. If, however, the theory is that insider trading is unfair to traders, recovery should be equal to the traders’ contemporaneous trading “losses”—typically significantly greater than the insider’s gains. If the theory is that insider trading undermines the integrity of trading markets, recovery should be disgorgement of the insider’s trading gains to the market as a whole. If the theory is that those who engage in insider trading pilfer valuable commercial information, recovery should be based on the losses to the owner of the confidential information.

Congress has addressed the issue and adopted a recovery scheme that borrows from both the unfairness and disgorgement rationales. The Insider Trading and Securities Fraud Enforcement Act of 1988 limits recovery to traders (shareholders or investors) whose trades were contemporaneous with the insider’s. Recovery is based on the disgorgement of the insider’s actual profits realized or losses avoided, reduced by any disgorgement obtained by the SEC under its broad authority to seek injunctive relief (see below). Exchange Act §20A.

Civil Recovery by “Defrauded” Source of Confidential Information

Owners of confidential information who purchase or sell securities can bring a private action under Rule 10b-5 against insider traders and tippees who adversely affect their trading prices. See Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975) (actual purchaser or seller standing requirement). A “defrauded” company may recover if it suffered trading losses or was forced to pay a higher price in a transaction because the insiders’ trading artificially raised the stock price. FMC Corp. v. Boesky, 673 F.2d 272 (N.D. Ill. 1987), remanded, 852 F.2d 981 (7th Cir. 1988) (holding tippee not liable for
trading on misappropriated information concerning company’s impending recapitalization plan because company lost nothing in the recapitalization). Although some commentators proposed corporate recovery on behalf of shareholders, courts have insisted on a corporate (not shareholder) injury for there to be corporate recovery.

**SEC Enforcement Action**

The SEC can bring a judicial enforcement action seeking a court order that enjoins the inside trader or tippee from further insider trading (if likely to recur) and that compels the disgorgement of any trading profits. *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968) (ordering establishment of fund from which shareholders and other contemporaneous traders could recover from insider traders and tippers).

**Civil Penalties**

To add deterrence, the SEC can also seek a judiciably imposed civil penalty against those who violate Rule 10b-5 or Rule 14e-3 of up to three times the profits realized (or losses avoided) by their insider trading. Exchange Act §21A (added by the Insider Trading Sanctions Act of 1984). The penalty, paid into the federal treasury, is in addition to other remedies. Thus, it is possible for an insider or tippee to disgorge her profits (in a private or SEC action) and pay the treble-damage penalty.

**“Watchdog Penalties”**

To create even more deterrence, the SEC can seek civil penalties against employers and others who “control” insider traders and tippers. Exchange Act §21A (added by Insider Trading and Securities Fraud Enforcement Act of 1988). Controlling persons are subject to additional penalties up to $1 million or three times the insider’s profits (whichever is greater) if the controlling person knowingly or recklessly disregards the likelihood of insider trading by persons under its control. Broker-dealers that fail to maintain procedures protecting against such abuses may also be subject to these penalties if their laxity substantially contributed to the insider trading.

**“Bounty Rewards”**

To encourage informants, the SEC can pay bounties to anyone who provides information leading to civil penalties. The bounty can be up to 10 percent of the civil penalty collected. Exchange Act §21A(e) (added by Insider Trading and Securities Fraud Enforcement Act of 1988). This bounty program is in
addition to the “whistleblower” bounty program created by Dodd-Frank. See Exchange Act §21F (see §12.3.5).

Criminal Sanctions

To punish those who engage in “willful” insider trading—that is, insider trading where the defendant knows that it is wrongful—the SEC can (and often does) refer cases to the U.S. Department of Justice for criminal prosecution. Exchange Act §32(a). Congress has twice increased the criminal penalties for violations of the Exchange Act and its rules. In the Insider Trading and Securities Fraud Enforcement Act of 1988, Congress increased the maximum criminal fines from $100,000 to $1,000,000 ($2,500,000 for nonindividuals) and jail sentences from five years to ten years. Then in the Sarbanes-Oxley Act of 2002, Congress upped the maximum fines to $5,000,000 ($25,000,000 for nonindividuals) and jail sentences to 20 years. Sarbanes-Oxley §1106, Exchange Act §32(a).

The Exchange Act’s criminal provisions provide a curious defense against incarceration for violating an SEC rule if the defendant “proves he had no knowledge of such rule.” Exchange Act §32(a). Courts have denied the defense if the defendant recognized he was engaged in deception.

§23.3.5 Regulation FD and Selective Disclosure

Inside information does not stay bottled up in companies forever. Sooner or later, companies communicate to securities markets. Formal disclosure in SEC filings is the soul of federal securities regulation. Informal disclosure, particularly by means of selective discussions with securities analysts and large investors, has been controversial—criticized as systematic tipping of valuable inside information and praised as an efficient way to reveal information to securities markets.

In 2000 the SEC took to heart the criticisms and adopted Regulation FD (Fair Disclosure) to forbid public companies from selectively disclosing material, nonpublic information. Exchange Act Rel. No. 43,154 (2000). The detailed rules on how companies may respond to analyst inquiries and engage in investor relations have altered how company information reaches securities markets. Disclosure practices once widespread, such as giving detailed financial projections to selected securities analysts or reviewing analyst reports before public release, are now regulated.

Regulation FD applies to issuer disclosures of material, nonpublic information to specified market professionals, as well as security holders who it is “reasonably foreseeable” will trade on the basis of the information. Rule 100(b)(1). When the disclosure is “intentional,” issuers must disclose inside information to the investing public simultaneously with any disclosure.
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to selected analysts or investors. Rule 100(a)(1). If the issuer discovers it has made an “unintentional” selective disclosure, the issuer must disclose the information to the public promptly (generally within 24 hours). Rule 100(a)(2). The information must be disseminated by methods “reasonably designed to achieve broad non-exclusionary distribution to the public”—such as through Internet postings or simulcasts, or by furnishing a Form 8-K to the SEC. Rule 101(e) (defining “public disclosure”). The restrictions apply to the issuer’s senior officials and those who regularly communicate with analysts and investors, such as investor relations or public relations officers. Rule 101(f).

The “equal access” rules of Regulation FD have some important exclusions [Rule 100(b)]—

<table>
<thead>
<tr>
<th>Context</th>
<th>Disclosure allowed</th>
</tr>
</thead>
<tbody>
<tr>
<td>Normal course of business</td>
<td>Disclosure may be made in the normal course of business, such as to professional advisers (attorneys, investment bankers, or accountants) or business partners in contract negotiations. Dodd-Frank calls on the SEC to eliminate the exclusion for credit rating agencies, unless the credit rating agency receives the information pursuant to a confidentiality or nondisclosure agreement. Dodd-Frank §939B.</td>
</tr>
<tr>
<td>Public disclosures</td>
<td>Disclosure may be made to media or government officials, such as by responding to newspaper inquiries or complying with regulatory investigations.</td>
</tr>
<tr>
<td>Public offerings</td>
<td>Disclosures may be made in securities offerings registered under the Securities Act, such as to analysts and institutional investors in going-public “road shows.”</td>
</tr>
<tr>
<td>Foreign private issuers</td>
<td>Disclosure may be made by foreign private issuers (which, if they meet the jurisdictional requirements, remain subject to the securities antifraud provisions).</td>
</tr>
</tbody>
</table>

To take some of the sting out of these rules, Regulation FD is enforceable only through SEC enforcement actions and does not give rise to 10b-5 liability or private enforcement. Rule 102.

Regulation FD is an important step toward a systematic regulation of inside information. Rather than dealing with each selective disclosure as a possible instance of “tipping,” the regime encourages wide dissemination of information—whenever the issuer decides to disclose. The rules encourage the release of information, not its suppression—consistent with the
§23.4 Regulation of Insider Trading UNDER Sarbanes-Oxley

philosophy of securities regulation that all investors have access to the same company-provided information at the same time. The rules also avoid the potential conflicts that analysts once felt to report favorably on companies to protect the flow of selective disclosures and that company executives felt to delay public disclosure so as to curry favor with preferred analysts or institutional investors.

In 2002 the SEC brought its first enforcement actions under Regulation FD. In one case, a company CFO called a handful of analysts to explain that their reports had failed to note that company earnings usually were higher in the second half of the year. The SEC issued an administrative cease-and-desist order, pointing out the company should have publicly disclosed the seasonality of its earnings before calling the analysts. When the company balked and the agency brought a judicial enforcement action, however, the court concluded that the CFO’s statements had already been disclosed (or were available) to the public, in the process chiding the SEC for being too linguistic and for chilling company disclosures. SEC v. Seibel Systems, 384 F.Supp.2d 694 (SDNY 2005). The court, however, did not address the fact that investors privy to the CFO’s statements bought the company’s shares, causing the stock price to surge. In short, the market’s reaction to the private information suggested its materiality, even though the court’s parsing of words led to a different conclusion.

§23.4 REGULATION OF INSIDER TRADING UNDER SARBANES-OXLEY (REVISED BY DODD-FRANK)

In response to the corporate scandals of the early 2000s, the Sarbanes-Oxley Act of 2002 regulates insider trading by company executives in two new situations: during pension fund blackouts and during the year before financials are restated. The Dodd-Frank Act of 2010 adds new “clawback” requirements for public companies.

§23.4.1 Insider Trading during Pension Plan Trading Blackout

Sarbanes-Oxley seeks to prevent insiders from “abandoning a sinking ship” while other employees are prevented from selling their stock. Sarbanes-Oxley §306(a). Directors and officers are prohibited from trading in their company’s stock during any “trading blackout” in the company’s pension plan—that is, when for more than three consecutive business days a majority of plan participants cannot obtain distributions or trade company stock
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held in the plan. ERISA §101, 29 U.S.C. §1021(h). The prohibition applies to any stock obtained by the director or officer in connection with his service or employment, whether or not held in the plan. The prohibition is meant to prevent company management from freezing trading in the company’s pension plan for ordinary employees while dumping their own stock during a decline in the company’s stock prices. Not only must the pension plan administrator notify plan participants (and the SEC) of the blackout, but the company must also notify directors and officers of the prohibition against trading in company stock. See Regulation BTR, Rule 104 (specifying contents and timing of notice).

Any trading profits realized by the director or officer during a trading blackout are recoverable by the company, regardless of intent—much like the strict liability scheme for short-swing profits under §16(b). See §24.3. The action to recover trading profits may be brought as a direct suit by the company or as a derivative suit by a shareholder after making demand on the company’s board. The suit must be brought within two years after the profits are realized. See Regulation BTR, Rule 103 (specifying “profit recoverable” to be difference between the transaction price and the average market price after the end of the blackout).

Unlike short-swing trading, which only triggers reporting requirements and the possibility of disgorgement in private litigation, trading during a pension plan blackout is prohibited. Thus, directors or officers who trade during such a blackout may also be subject to SEC enforcement actions and even criminal sanctions.

§23.4.2 Reimbursement ("Clawback") of Incentive Pay when Financials Misstated

Sarbanes-Oxley “Clawback” Regime

Sarbanes-Oxley created a regime calling on corporate executives in public companies to reimburse the company for incentive pay when the company must restate its financials because of “misconduct.” Sarbanes-Oxley §304 (adding 15 U.S.C. §7243). Specifically, the CEO and CFO are required to reimburse the company for any incentive pay (such as bonuses or equity-based compensation) received from the company during the 12-month period after the misstated financials were issued or filed. This “reimbursement” duty also applies to any profits on the sale of company stock by the CEO or CFO during the same period.

The Sarbanes-Oxley reimbursement provisions sought to prevent a company’s top officers from profiting from false financials. The provisions, for which legislative history was scant, introduced numerous uncertainties: (1) Do voluntary restatements trigger a reimbursement duty? (2) What
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individuals are covered? (3) Are private actions (including derivative suits) available or only SEC enforcement? (4) Are negligent misstatements or only intentional ones considered misconduct? (5) How are trading profits calculated? (6) Can a company create its own definitions of misconduct and trading profits? (7) What is the statute of limitations?

There have been some answers to these questions, but only a few. Courts have uniformly interpreted §304 not to create a private cause of action, but only a basis for an SEC enforcement action. See Neer v. Pelino, 389 F. Supp. 2d 648 (E.D. Pa. 2005) (plain language of Sarbanes-Oxley, buttressed by legislative history, precludes private right of action). The SEC, however, has brought few enforcement actions.

Dodd-Frank “Clawback” Regime

In response to the many weaknesses and unanswered questions of the §304 clawback regime, Dodd-Frank created a new one. Dodd-Frank §954. Under new §10D to the Exchange Act, the SEC is required to impose rules on the national stock exchanges that would compel listed companies to adopt “clawback” policies for the recovery of any incentive-based compensation (including stock options) from current or former executive officers for the prior three years in the event of a financial restatement due to material noncompliance with any financial reporting requirement under the securities laws. The amount to be recovered is set at the difference between the amount of incentive-based compensation received and the amount that should have been received under the restated financial results.

The §954 regime of Dodd-Frank is different from the §304 regime of Sarbanes-Oxley. First, the new clawback right is enforceable, not just by the SEC, but also in derivative actions whenever companies fail to seek such relief. Further, private plaintiffs may initiate litigation even when restatements did not occur, but should have occurred were it not for a conflict of interest by management. Second, while the §304 regime only allowed disgorgement from the company’s CEO and CFO, the §954 regime covers the company’s current and former “executive officers,” which presumably includes all officers subject to §16 reporting. Third, the §954 regime lowers the trigger for clawbacks to instances of “material noncompliance with applicable accounting principles,” while the §304 regime was limited to restatements resulting from “misconduct.” Fourth, the §954 regime extends the look-back period from one year to three years.

Despite adding greater clarity—and increasing the likelihood of enforcement—the §954 regime leaves some important questions unanswered. First, if an executive and the company’s board fight the clawback, it is unclear whether the usual corporate law rules on board demand and dismissal of derivative litigation would apply. In particular, it is unclear whether the board (or a special litigation committee) could argue that the
benefits of any clawback are outweighed by the disadvantages. Second, it is unclear whether the SEC and stock exchanges would have any leeway in defining such terms as “executive officers” and “material noncompliance.” Finally, Dodd-Frank imposes no deadline for the SEC to issue rules to the stock exchanges or for the exchanges to pass the new clawback standards.

**Examples**

1. ITM Corp. is a publicly traded company with an active research and development department. Elbert, an ITM chemist, has conducted preliminary tests on a cobalt/phosphate film that electrolyzes (separates water into hydrogen and oxygen) at room temperatures. If the test results can be confirmed, it would be a huge scientific breakthrough with enormous commercial potential in storing energy generated by solar panels. Daniela, ITM’s president, learns of the tests and sends an intraoffice memo to all concerned urging complete secrecy.
   a. ITM’s board grants ITM stock to Daniela, who accepts. She does not tell the board of Elbert’s tests. Is Daniela liable to the corporation under Rule 10b-5?
   b. Daniela purchases “call” options (allowing her to buy ITM stock) on the options market. She does not trade with ITM shareholders. Is Daniela liable under Rule 10b-5?
   c. Elbert purchases ITM stock through a stockbroker under a written investment plan that calls for fixed, monthly purchases of ITM stock. Under the plan Elbert can choose to purchase more or fewer shares in any month, but he does not exercise this option. Is Elbert, who is neither a director nor officer of ITM, liable under Rule 10b-5?

2. After the test results are confirmed, but before public disclosure of the tests, Elbert tells Elsa (a fellow physicist who works for another research company) of the low-cost electrolysis breakthrough.
   a. Elsa buys ITM stock. Is she liable under Rule 10b-5?
   b. Elbert does not trade himself, but reveals the ITM test results to Elsa hoping to receive similar market-sensitive scoops from her. Assuming Elsa never reciprocates with information of her own, is Elbert liable under Rule 10b-5?
   c. Elbert and Elsa discuss the future of electrolysis and its impact on energy policy while riding in a limousine on their way to a scientific conference. Mickey, the limo driver, overhears their conversation and the next day purchases ITM stock. Is Mickey liable under Rule 10b-5?

3. Still before the electrolysis breakthrough is disclosed publicly, Daniela tells her husband Donald (from whom she is separated) that he should reconsider divorcing her since she stands to become wealthy because of
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a “top secret breakthrough” at ITM. She asks him to keep the information confidential.

a. Instead, Donald buys ITM call options. Has he violated Rule 10b-5?
b. Donald also tells a colleague at his office that “Daniela tells me there’s a breakthrough at ITM — you should buy.” The colleague does. Has the colleague violated Rule 10b-5?
c. Donald and his good friend Martha have the same stockbroker, Merton. When Donald tells Merton to purchase ITM stock options, Merton assumes Donald knows from Daniela that something good is afoot at ITM. He calls Martha and says simply, “Donald’s buying.” Martha buys ITM stock. Has she violated Rule 10b-5?

4. Meanwhile, at company headquarters Daniela receives a phone call from Raymond, a securities analyst who follows high-tech companies. Daniela tells Raymond, “There have been significant developments in our energy-storage research.” Daniela hopes to signal to the market the impending good news.

a. Raymond tells his clients that ITM should be viewed as a “strong buy.” Has Daniela violated any duties?
b. Daniela calls you, the company’s lawyer, and asks for your advice on how to handle disclosures about ITM’s electrolysis research and results to securities analysts. Can she talk with you, and what would you advise?

5. Before public disclosure of the electrolysis breakthrough, Daniela discloses it to Wilbur (the president of Third Federal Bank) to obtain a loan for ITM to build a new manufacturing plant. Daniela asks Wilbur to keep the information secret.

a. Wilbur calls his stockbroker and buys ITM stock. Is Wilbur liable under Rule 10b-5?
b. Wilbur tells his wife Wanda over dinner that ITM’s stock price is “probably going to go through the ceiling.” Wanda asks no more but buys ITM stock. Is Wilbur or Wanda liable under Rule 10b-5?
c. Tina, a corporate spy, breaks into Third Federal’s offices and rifles the files to find the ITM loan application. She buys ITM stock. Is Tina liable under Rule 10b-5?

6. ITM’s board decides it should be prepared to add manufacturing capacity to produce electrolysis machines using the company’s cobalt/phosphate process. It decides to acquire Ovid Corporation, a publicly traded industrial builder, to build new manufacturing plants. ITM secretly negotiates an acquisition of Ovid.

a. Before announcing the acquisition, ITM purchases a significant block of Ovid stock. Is ITM liable to Ovid shareholders under Rule 10b-5? Rule 14e-3?
b. ITM decides to proceed with a tender offer, but before announcing its bid the ITM board authorizes Daniela to purchase a limited amount of Ovid stock on the market. Is Daniela liable under Rule 10b-5? Rule 14e-3?

c. Ovid shareholders who sold during the period between Daniela’s trading and eventual disclosure of the merger sue Daniela to recover the gains they would have made if they had not sold. Is Daniela liable to these shareholders under Rule 10b-5?

d. Daniela makes $100,000 in trading profits by buying Ovid stock. What is her maximum monetary exposure?

e. Daniela attends a stock analysts’ meeting, which is simulcast on the company’s website. She announces that ITM will manufacture its new electrolysis machines, but does not mention new manufacturing plants or the pending acquisition of Ovid. One of the analysts, Tom, figures out that ITM is likely to acquire Ovid. Tom tells his clients, who buy Ovid stock. Is Tom liable under Rule 10b-5?

Explanations

1. a. Yes, probably. Insider trading duties also apply to trading with one’s corporation. As a corporate insider, Daniela has a fiduciary relationship to ITM and, under Rule 10b-5, a duty to abstain or disclose when trading with the corporation on the basis of material, nonpublic information. Chiarella (§23.3.1). An insider trading case under Rule 10b-5 must also satisfy the fraud elements of materiality and scienter—

   • Materiality. The information about the preliminary tests is material if a reasonable investor would consider it important to a buy-sell decision. Under the “probability plus magnitude” test of Basic, Inc. v. Levinson, 485 U.S. 224 (1988) (§22.3.1), the magnitude of discovering a low-cost electrolysis process would be demonstrated by a post-disclosure jump in ITM’s stock price. The probability that the preliminary tests would confirm the process’s effectiveness seem high.

   • Scienter. Daniela knew of the tests when she accepted the options and should have been aware of their propensity to affect the value of the company’s stock. See §22.3.2. It is not necessary that she actually used this information, but that she was aware of it. Rule 10b5-1.

   When trading involves nondisclosure, the Supreme Court has presumed reliance upon a showing that the undisclosed information was material. Affiliated Ute Citizens v. United States, 406 U.S. 128 (1972) (§22.3.3). In this face-to-face transaction, Daniela might nonetheless rebut the assumption of reliance by showing that the corporation (acting through an independent board) would have offered the options anyway, even had it known of the inside information.
b. Yes, almost certainly. Daniela’s abstain-or-disclose duty extends to shareholders and other investors in ITM’s stock. Chiarella (§23.3.1). Does it extend to nonshareholder investors? Before 1984, some courts had held that option traders were owed no duty of disclosure. The Insider Trading Sanctions Act of 1984, however, closed this judge-made loophole by explicitly prohibiting trading in any derivative instrument if trading in the underlying securities would violate insider trading rules. See Exchange Act §20(d).

Although materiality would seem an issue, it rarely is in insider trading cases. If the insider considered the information important to her buy-sell decision, it is almost certain that a court will conclude that a “reasonable shareholder” would also consider the information important—and thus material.

c. Probably, because the trading plan left some discretion to Elbert. The 10b-5 insider trading rules apply to any corporate insider with a fiduciary (or agency) relationship to the corporation. Elbert, an employee-agent of ITM, is subject to the same duties as Daniela. His awareness of the test results would establish a culpable state of mind, subject to an affirmative defense that the trading plan was such that the stock purchases would have happened regardless of his inside knowledge. Elbert would have to show he entered into the written plan before he was aware of the low-cost electrolysis breakthrough and the plan specified the terms of purchases, contained a formula for these terms, or disabled him from influencing the broker. Rule 10b5-1(c). That Elbert retained the option to increase or decrease the purchases each month means the plan was not fixed, as required by the SEC safe harbor rule for plan purchases.

2. a. Perhaps, depending on Elbert’s motives and expectations. If Elsa knows (or has reason to know) that the information was confidential and came from an insider who tipped for some personal or reputational benefit, Elsa is liable as a tippee. Dirks. A significant issue is whether Elbert disclosed the breakthrough for personal gain or for some nonpersonal corporate reason. If he expected reciprocal stock-trading tips or personal reputational gain, the tip violated Rule 10b-5 if Elsa had reason to know those were his motives. If, however, Elbert revealed the breakthrough for business reasons, such as to discuss the scientific aspects of the discovery, Elsa is under no confidentiality obligation. Elsa’s liability thus hinges on Elbert’s motives—a deficiency of the Dirks approach, but part of federal insider trading law.

In addition to his motives, Elbert’s expectations of confidentiality might also be relevant. If Elsa and Elbert have exchanged confidential information in the past so that Elsa had reason to know that Elbert expected confidentiality, it might be argued she became a “temporary
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insider.” In its recent Rule 10b5-2, the SEC has inferred a duty of trust and confidence in such circumstances. Although the rule by its terms applies only to misappropriation liability, its logic extends to identifying temporary insiders in cases of classic insider trading.

b. Yes. Elbert is liable as a tipper because he gave the tip in breach of his fiduciary duty for an improper personal benefit—the expectation of future reciprocal tips. Even though Elbert did not trade himself, a tipping insider is liable for placing confidential nonpublic material information in peril of abuse. SEC v. Texas Gulf Sulphur (see §23.2.1). Under this aiding and abetting theory, nontrading tippers are jointly and severally liable to the same extent as their trading tippees. See Exchange Act §20A(c).

c. Perhaps, though not as a tippee. If Elbert did not anticipate a personal gain from his discussion or there was an expectation of confidentiality, there was no breach of Elbert’s duty and a tippee (or an eavesdropper) could not be liable on that basis.

Nonetheless, Mickey might be liable on a misappropriation theory. If Mickey worked for a limousine company that expected complete discretion of its employees, he could be liable for misappropriating the information in breach of his employer’s expectation of confidentiality. See United States v. O’Hagan (§23.3.3). His trading would constitute a breach of duty owed to his employer if the employer expected that he would not divulge or use for personal purposes any information obtained on the job. The SEC confirmed this analysis by defining a relationship of “trust or confidence” to include a contractual relationship (though not necessarily creating a fiduciary relationship) in which there was an agreement of confidentiality. Rule 10b5-2(b).

One sticking point might be whether Mickey had the requisite state of mind. Although his awareness of the importance of the electrolysis breakthrough would appear to satisfy the general “awareness” standard for civil liability, see Rule 10b5-1(b), it may not be enough to establish the “willfulness” required for criminal liability. The O’Hagan court pointed out that under Exchange Act §32(a) a criminal 10b-5 defendant cannot be imprisoned if he “has no knowledge of the rule.”

3. a. Probably. The question is whether Donald is a “constructive insider” who has a duty of confidentiality because of his relationship to Daniela. Although earlier courts held that within a family duties not to trade on material, nonpublic information arise only if there were express understandings of confidentiality, recent courts have followed the lead of the SEC (see Rule 10b5-2) and treated spousal communications as carrying a duty of confidentiality if the spouses had an express or implied understanding of confidentiality. See SEC v. Yun (§23.3.3). By
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asking Donald to keep the information confidential, Daniela expected he would not use the information. Only if Donald could show her expectation was unfounded, perhaps because of his past indiscretions, would the presumption of spousal confidentiality be rebutted.

Notice that this is not a case of tipping. When Daniela told Donald of the breakthrough it was not in the belief he would trade on it—in fact, she asked him to keep it confidential. Much like the spouse in SEC v. Yun, who told his wife during divorce discussions about an impending drop in the company’s stock, Daniela’s revelation was meant to preserve the marriage, not facilitate advantageous stock trading. Spousal communications about work do not constitute a fiduciary breach if the communications are not intended as a stock tip.

b. Probably. The question here is whether the colleague is liable as a tippee. If Donald was a “constructive insider” (see previous answer), the issue becomes whether the colleague knew or had reason to know that Donald’s tip violated his duty of confidentiality, which requires that Donald expected a personal benefit from the tip. See SEC v. Musella, 678 F. Supp. 1060 (S.D.N.Y. 1988) (holding two New York City police officers liable as tippees for receiving information from another officer, who had received it from an employee of a Wall Street law firm, on the grounds they “should have known” the original tip was a breach of fiduciary duty). Since the colleague knew that Donald had received the tip from Daniela, he should have (at the least) inquired whether Donald was expected to keep it secret. If the colleague had reason to know that Donald was not supposed to reveal the information, a personal benefit is virtually presumed—for example, it would be enough that Donald hoped for a good relationship with a workplace colleague. See SEC v. Yun (see §23.3.3). Courts have used the same broad analysis as to what constitutes a “personal benefit” in cases of classic insider trading and misappropriation. If the tipper wrongfully tips the information and anticipates the tip will result in some financial or reputational gain (however slight)—and the tippee should know this—liability is established.

c. Perhaps not. This is much like the trading in which Martha Stewart was said to have engaged. Merely knowing that an insider is trading does not establish that he is trading on material, nonpublic information. That is, in the normal case there is no reason to believe that the trading breached a fiduciary duty. Unless the tipper—here, the broker Merton—told Martha that Donald was trading on the basis of specific inside information, it may be difficult to establish the tippee’s requisite state of mind. Under Rule 10b-5, trading must be with scienter to be actionable in an administrative or private lawsuit (§22.3.2), and must be “willful” to be criminal. Exchange Act §32(a). Perhaps for this reason, the SEC only brought an administrative action against Stewart
seeking fines and disgorgement of her insider trading profits. In 2006, she settled these charges without admitting or denying any wrongdoing for $195,000, representing a trebling of the losses avoided plus interest. The criminal case against her was based not on her trading, but on false statements she made to SEC investigators about her reasons for selling her stock.

4. a. Probably. Daniela has clearly violated Regulation FD if her disclosure of the electrolysis breakthrough was to only one securities analyst. Senior officials of publicly traded companies are obligated to disclose material information simultaneously to the market when the disclosure is intentional. Here Daniela had already warned others in the company to keep the electrolysis test results secret — suggesting she understood the information was material and nonpublic. Rule 101(a) (definition of intentional). There does not appear to be any effort to disclose the information to other analysts or investors. Nor does any exception apply since Raymond was under no duty to maintain the information in confidence.

Whether Daniela has violated the 10b-5 insider trading rules is not as clear. A violation of Regulation FD does not automatically create 10b-5 liability. Rule 102. And an argument can be made that Daniela is not liable under Rule 10b-5 since she was not a tipper under Dirks. She disclosed the information not for any personal gain but to inform the securities markets. Nonetheless, one must wonder why she told only Raymond. If it was because he has given favorable reports on ITM in the past (boosting the value of Daniela’s stock options) and Daniela expects similar favors from him in the future, her disclosure might have violated her Dirks duties. At the least, Daniela risks being the target of an SEC investigation.

b. Regulation FD forces companies to institute policies and procedures for dealing with market inquiries. Although conversations are permitted with company advisors, such as lawyers who have a duty of trust and confidence to the company client, senior company officials must be careful in disclosing material, nonpublic information to market professionals and investors who are likely to trade on the information.

- **Materiality determinations:** Companies should have policies for determining what information is nonpublic and material — such as earnings information, important product or contract developments, and important acquisitions or extraordinary transactions. There should also be procedures for consulting with inside counsel and, when appropriate, outside counsel.

- **Identify authorized officials:** Companies should limit analyst and investor contacts to specific company spokespersons — such as the CEO, the vice president of finance, and the head of investor relations. Private
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meetings or phone calls between senior officials and securities professionals should be discouraged, particularly if material information may be discussed.

• **Coordinated disclosure.** Companies should have procedures for responding to both informal and formal contacts. There should be internal communications channels so that questions are directed to the right persons and responses are consistent. For example, responses to common queries could be posted on a company intranet, and scripts for analyst conferences should be prepared and reviewed in advance. There should be policies for prompt "debriefing" of informal contacts to cure unauthorized disclosures.

• **Wide dissemination.** Material disclosures should be disseminated by press release and accompanied by the filing of a Form 8-K. Any press conference or analyst calls should be conducted on the Internet to allow full media and investor access. These materials should also be archived for a set period, such as seven days. It may be useful to file a provisional Form 8-K to announce generally how the company will disseminate material, nonpublic information.

• **Forward-looking disclaimers.** Since many queries will ask for management’s predictions and views about the future, the company should have policies for giving forward-looking statements that fit within the safe harbor rules. The speaker should identify the statement as predictive and refer the audience to risk disclosure in a readily available SEC filing Exchange Act §21E(c)(2). These risk disclosures should be updated periodically.

5. a. Yes, under a misappropriation theory. Daniela provided Wilbur information on the electrolysis tests on the condition that the bank keep it confidential. Wilbur, in effect, misappropriated this information from the bank. If the bank had a policy against employees using confidential customer information—which seems nearly certain—he would be liable on a misappropriation theory. The theory protects confidential business information and assures stock trading markets that trading with information purloined in a relationship of trust and confidence is prohibited.

Even if the bank did not have this policy, the new SEC rule defining the relationships that trigger misappropriation liability specifies that if there was a pattern of sharing confidences so Wilbur had reason to know Daniela expected confidential treatment, Wilbur would have a duty not to trade. Rule 10b5-2(b)(2). Although the bank was not an agent of ITM, since commercial lenders typically deal with borrowers on an arm’s-length basis, the SEC rule stretches the notion of trust and confidence beyond that of state agency law. Compare United States v. Chestman (see §23.3.3).

Notice, however, that Wilbur was not a tippee of ITM, since Daniela expected no personal gain from the disclosure and breached no duty
when she provided it. She supplied the information so her company could get a loan, something permissible under the selective disclosure rules of Regulation FD. Rule 100(b)(2)(i).

b. Both are liable. Tipper and tippee liability work the same in an outsider misappropriation case as in an insider trading case. See United States v. Falcone, 257 F.3d 226 (2d. Cir. 2001) (see §23.3.3 — Tipping of Misappropriated Information). If (as discussed in the prior answer) Wilbur is under an abstain-or-disclose duty because of his position at the bank or his taking of confidential information, he cannot tip the information. Wanda is liable as a tippee if she knew (or had reason to know) that Wilbur received the information in confidence and that Wilbur gained some personal benefit (such as a share of her trading profits) by disclosing it to her. She is liable as tippee, and he as tipper, for any trading gains.

c. No. Rule 10b-5 liability hinges on a relationship of trust and confidence, and there is none here. See O’Hagan. Tina does not have a relationship with and is not a fiduciary to either ITM or to Third Federal Bank. Nor has Tina agreed to maintain the information in confidence, nor is there any practice of sharing confidences with Tina from which an expectation of confidentiality might arise. See Rule 10b5-2(b). Although insider-trading prohibitions may be meant to protect confidential business information, 10b-5 liability is not so broad. Compare SEC v. Cherif, 933 F.2d 403 (7th Cir. 1991) (liability of former employee who used magnetic identification card to gain access to secret information on pending takeovers).

Tina might, of course, be liable for mail and wire fraud. See §23.3.3 — Mail and Wire Fraud. And, if any of the information she stole and traded on related to a tender offer, she would also be liable under Rule 14e-3. See § 23.3.3 — Rule 14e-3. Neither of these “information protection” rules requires a relationship of trust and confidence.

6. a. No. The trading does not breach any duty of trust and confidence. Chiarella and O’Hagan (§23.3.1). ITM has not misappropriated any information, since any proprietary interest in the information concerning the Ovid acquisition belonged to ITM. The company is merely exploiting its informational advantage, based on its own plans, and has no abstain-or-disclose duty.

This analysis is the same under Rule 14e-3, which applies to material, nonpublic information about a pending tender offer. Even if the Ovid acquisition were structured as a tender offer, the rule applies only to persons other than the “offering person.” Rule 14e-3(a).

b. Probably not under Rule 10b-5, though perhaps under Rule 14e-3. Because Daniela had permission to trade on information about ITM’s
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undisclosed plans, she did not misappropriate any information when she traded in Ovid’s shares. See O’Hagan. In these circumstances, there was no deception aimed at the source of the information, a necessary element for liability under the Supreme Court’s theory for liability in O’Hagan. Just as ITM’s trading on its own information would not violate Rule 10b-5 (see previous answer), Daniela’s trading could be seen as a form of additional, indirect trading by ITM itself. There might, however, be problems for ITM under federal line-item disclosure rules (or state corporate fiduciary law) if the company fails to disclose this implicit executive compensation, but not under Rule 10b-5.

Whatever Daniela’s authorization, she violated the terms of Rule 14e-3, which regulates trading on confidential information about a tender offer. See §23.3.3. The rule prohibits trading by “any other person” (besides the bidder) who possesses material, nonpublic information she knows is nonpublic and came from the bidder. Rule 14e-3. By its terms, Rule 14e-3 is violated even if there is no breach of a duty of trust and confidence. Does the SEC have the rulemaking power to regulate trading not in breach of a duty? Although the Supreme Court in O’Hagan upheld Rule 14e-3 as applied to a lawyer who had breached his duties by trading on confidential client information, the Court reserved “for another day” the legitimacy of Rule 14e-3 as applied to “warehousing,” the practice by bidders of leaking advance information of tender offers to allies and encouraging them to purchase target stock before the bid is announced. Like warehousing, Daniela’s authorized trading breaches no duty. As applied to Daniela, Rule 14e-3 may go beyond the SEC’s rulemaking power.

c. No, even if Daniela violated Rule 10b-5, only shareholders who traded “contemporaneously” with Daniela can recover. The Insider Trading and Securities Fraud Enforcement Act of 1988 provides an explicit private right of action to contemporaneous traders against misappropriators. Exchange Act §20A. At one time courts saw the misappropriation theory as protecting the confidences of the outside company, here ITM, and held that Rule 10b-5 did not protect trading shareholders, such as Ovid’s. The 1988 Act rejects this view. Liability, however, is not tied to the period during which the misappropriator failed to disclose, but rather the period of the misappropriator’s trading.

d. There is no cap, if she violated Rule 10b-5 or 14e-3. Daniela can be liable for her trading profits in a disgorgement proceeding by the SEC or in a restitution suit by contemporaneous traders—maximum $100,000. See Exchange Act §20A. In addition, she can be liable for additional civil penalties of up to three times her trading profits—maximum $300,000. Exchange Act §21A. She can also be subject to criminal fines—now up to $5 million. Exchange Act §32(a). Finally, she can be liable for any losses to ITM if it had to pay more
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for the merger because of the signaling inherent in her trading—no maximum. All for a $100,000 trading gain!

e. No. Although Tom revealed nonpublic, confidential information to his clients (namely the likely ITM acquisition of Ovid), he ascertained it from public information and thus breached no duty. Nor did Tom have any duty to ITM (the source of the information) or Ovid (the company whose shares were traded).

But didn’t Tom misappropriate information about ITM’s likely merger with Ovid from his own brokerage firm? Although the brokerage firm could have used this information to its advantage, it is unlikely the firm has a policy against analysts disclosing their analysis to clients. In fact, Tom’s job is probably to do precisely what he did. The Supreme Court in Dirks recognized the crucial role securities analysts play in disseminating information to the market.