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Overview of the Law of Insider Trading

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This chapter provides an overview of the law of insider trading, touching briefly on topics that receive closer attention in the rest of this book. It begins with definitions of the basic elements of insider trading. It then discusses the persons who may be subject to the laws prohibiting insider trading, and the kinds of penalties that might be imposed upon them for a violation of the law.

The policies underlying the law have been debated, and the chapter continues with a discussion of those policies. It concludes with an account of the evolution of insider trading law, emphasizing how its early boundaries have been expanded by the Supreme Court, the Congress, and the Securities and Exchange Commission (SEC).

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Definitions

Q 1.1 What is insider trading?

Insider trading occurs whenever any person or entity (1) trades in any “security” (2) “on the basis of” (3) material, (4) nonpublic information (5) which has been obtained in breach of a duty of trust or confidence.¹

Q 1.1.1 What is a security?²

The term “security” encompasses a wide variety of different instruments and interests, including but not limited to common and preferred stock, treasury stock, notes, bonds, debentures, certificates of interest, puts, calls, straddles, options, or privileges on any security, and any security-based swap or other derivative instrument.³

Q 1.1.2 What is trading “on the basis of”?

A person trades “on the basis of” material nonpublic information with respect to a security if the person was *aware* of the material nonpublic information at the time the person purchased or sold the security.⁴

Q 1.1.3 What is material information?

Information is material if there is a substantial likelihood that a reasonable investor would consider it important in making an investment decision.⁵ Put another way, a given piece of information is material if a reasonable investor would consider it as having significantly altered the mix of information already publicly available.⁶ Thus, mate-

riality often hinges on the significance a reasonable investor would place on the information.⁷

The courts have not adopted a bright-light test for materiality, nor has the SEC. But both case law and SEC pronouncements offer numerous examples of potentially material information, including earnings information; mergers, acquisitions, tender offers, joint ventures, or changes in assets; significant new products or discoveries, or significant developments regarding customers or suppliers; changes in control or in management; change in auditors; significant events regarding the issuer's securities; and bankruptcies or receiverships.⁸

Q 1.1.4 What is nonpublic information?

Information is considered to be nonpublic if it has not been disseminated broadly to investors in the marketplace.⁹ Direct evidence of dissemination is the best indication that information is "public," for instance, if the information has been made available to the general public through the media or in public disclosure documents filed with the SEC. In addition, a sufficient period of time must pass for the information to permeate through the public channels to be considered public.¹⁰ The object is for the information to be available to and digested by the market such that it is reflected in the market's pricing of the security.

Q 1.1.5 Who is an insider?

The term "insider" is not expressly defined by the securities laws or the SEC rules but has been construed by the courts to refer to a person or entity that by virtue of a fiduciary relationship with an issuer of securities has knowledge of, or access to, material nonpublic information.¹¹ An insider is one who typically stands in a position of trust and confidence to the company and its shareholders, such as an officer, director, controlling shareholder, or employee of a company.

Scope of Enforcement

Q 1.2 Do the insider trading laws only apply to corporate officers?

No. Although corporate officers owe a fiduciary duty to their shareholders—to use corporate information only for the benefit of the corporation and not for their own personal benefit—the prohibition against insider trading goes far beyond corporate officers. Indeed, any corporate employee, not just an officer or director, owes the same duty to corporate shareholders to use information entrusted to them by the corporation solely for the corporation’s purposes and not for personal benefit (either by engaging in personal trading or from sharing that information with others who then use it to trade—a process known as “tipping”).¹² This duty gives rise to what is known as the “abstain-or-disclose” doctrine, by which a corporate insider is required to either abstain from personal trading (or “tipping” others) while aware of material nonpublic information relating to his or her corporate employer or ensure that that information is fully disclosed and disseminated to the market as a whole before engaging in personal trading.¹³

Q 1.3 Do the insider trading laws apply beyond corporate employees?

Yes. There are many people and entities that may not be direct employees of the corporation but who still are considered “insiders,” and who therefore have the same duty to disclose the information they possess to the market as a whole or abstain from trading (or passing the information on to others who may trade) while aware of material nonpublic information.¹⁴

Thus, auditors, outside accountants, brokers, investment bankers, outside counsel, and the like all owe a similar duty to use information entrusted to them by their corporate client only for the corporation’s interests. Such individuals are referred to as “temporary insiders” and they too are prohibited from trading in their corporate client’s securities while aware of the client’s material nonpublic information.¹⁵

Q 1.4 If I am not employed by or otherwise affiliated with the corporation whose securities I wish to trade, do the insider trading laws apply to my trades?

Yes. There are two different ways that the prohibition against insider trading can apply to a person even if that person has no employment or other connection to the company. First, if the person received material nonpublic information from a corporate insider and trades based upon that information, the person can be liable as a “tippee.”¹⁶ Second, even a person with no relationship to the corporate issuer can be liable for insider trading under the “misappropriation theory” for utilizing information obtained in breach of a duty of trust or confidence.¹⁷ Determining when such information has been obtained in breach of a duty of trust or confidence can be a complex matter and, therefore, is treated in more detail in chapter 9.

Q 1.5 Could the prohibition against insider trading apply to me if I do not trade in any securities?

Yes, but only in the narrow circumstance where you have learned material nonpublic information from either a corporate insider or someone who has breached a duty of trust or confidence to the source of the information *and* you then share that information with someone else who does trade in securities.¹⁸ In that circumstance, even though you personally made no trade in the issuer’s securities, you can be liable as a “tipper” for the trading done by the person to whom you passed the information.¹⁹ For that reason, it is important never to pass on material nonpublic information to anyone else who may actually trade while aware of that information or who may pass it on to others who may trade.

Q 1.6 Who enforces the prohibition against insider trading?

Several enforcement mechanisms exist to enforce the prohibition against insider trading.

First, the SEC brings civil enforcement actions under either section 10(b) or section 14(e) of the Securities Exchange Act of 1934 (1934 Act) and Rule 10b-5 promulgated thereunder. The SEC has broad regulatory authority to enact new and amend existing rules,

and to oversee securities investigations and private regulatory organizations in the securities fields.

Second, the Department of Justice, through the United States Attorneys' Offices, pursues criminal prosecutions pursuant to the same provisions of the 1934 Act as the SEC by investigating, collecting evidence against, and prosecuting individuals and entities suspected of insider trading.

Third, the 1934 Act establishes a private right of action in favor of contemporaneous traders against any person who violates the 1934 Act or the SEC rules promulgated thereunder.²⁰ Accordingly, private individuals can bring actions for damages against insider traders, "tippees," and their own corporation (in a shareholder derivative action).²¹

Q 1.7 What are the penalties for insider trading?

Insider trading creates exposure to both criminal and civil liability. The range of criminal penalties depends on the degree of the misconduct and the level of culpability involved. As a threshold matter, a person may be prosecuted for insider trading only if he or she committed a "knowing or willful" violation of the securities laws. If the alleged wrongdoer is found to have committed such a violation, federal prosecutors may seek a term of imprisonment of up to twenty-five years and/or monetary fines of up to \$5 million in the case of individuals and \$25 million in the case of entities.²² Sentences are imposed pursuant to the Federal Sentencing Guidelines, which establish various factors for the courts to take into account during the sentencing phase, such as the profits made or losses avoided as a result of the insider trading, whether a position of "special trust" was abused, and whether the defendant cooperated with the government (as well as the degree of any such cooperation).²³

Another ground for criminal remedies is the Mandatory Victims Restitution Act of 1996 (MVRA), which mandates restitution for securities fraud victims and other victims of fraud or deceit. The primary objective of MVRA is to make victims of crimes whole, so courts are not authorized to consider the defendant's economic circumstances in making a restitution order.²⁴

In civil suits, remedies available against persons or entities found liable for insider trading include disgorgement of profits gained or

loss avoided by the insider trading,²⁵ monetary penalties of up to three times the illicit windfall,²⁶ suspension or bar from being (or being associated with) a broker-dealer or investment adviser, injunctive relief to prevent existing and future securities law violations,²⁷ freezing assets,²⁸ and punitive damages in certain circumstances.²⁹

Individuals trading contemporaneously with an insider trader also have a private right of action against the violator under section 20(A) of the 1934 Act. Section 20(A) allows the recovery of pecuniary damages in the amount suffered by the contemporaneous trader, limited to the profits gained or losses avoided by the insider trader, less any disgorgement previously obtained in an SEC enforcement action.³⁰

The Policy Debate

Q 1.8 What are the public policies underlying the prohibition against insider trading?

The prohibitions against insider trading prevent fraud, manipulation, and deception in the capital markets. The policies underlying these prohibitions emphasize basic principles of fairness, market integrity and efficiency, and social justice.³¹

The fairness consideration is intended to protect both outside investors and shareholders of a corporation. An insider is a fiduciary of the corporation with access to material nonpublic information that could significantly affect the corporation. As a result, policymakers have determined that it would be unfair to allow corporate insiders to exploit such information for personal gain, as it is the exclusive property right of the corporation.³² The corporation has invested substantial resources into developing the valuable information, and a fiduciary should not be unjustly enriched through the improper use of such information. Further, it is unfair for corporate insiders to have an informational advantage over outside investors based upon the insiders' access to material corporate secrets.

The fairness justification is implicitly based on upholding marketplace integrity. Insider trading laws seek to instill confidence in the securities marketplace by ensuring that insiders are not the only investors profiting from securities trades.³³ The concern is that outside investors, especially risk-averse ones, may be deterred from

entering a market where corporate insiders trade on material nonpublic information. Efforts to curb insider trading are intended to increase investor confidence in the securities markets and, in turn, enhance capital formation.³⁴ The Supreme Court in *O'Hagan* made clear that while some information disparity between insiders and outsiders is inevitable, investors will hesitate to invest in a market where insider trading is unchecked by the law.³⁵ The insider trading laws seek to reduce the risk that insiders will use material nonpublic information to the detriment of the corporation by preventing insiders from selling the information to outsiders for money, reciprocal information, reputational gains (such as increased clientele or business), or other valuable benefits. The insider trading laws also seek to eliminate any possible quid pro quo arrangement where an insider and noninsider trade valuable market information to the detriment of shareholders and other outside investors.³⁶

Finally, an emphasis on social justice and emotion-based moral arguments also underlie the insider trading laws.³⁷ The securities laws and SEC rules seek to keep the “mom and pop” shareholders or “widows and orphans” from being disadvantaged by corporate insiders, who are often portrayed as “insidious people who have little regard for morality and could care less about their reputation.”³⁸ Social justice grounds the insider trading laws as a way to deter insiders from stealing from the “little guy.”³⁹

Q 1.8.1 Is insider trading law intended to ensure that everyone has the same information?

No. Insider trading law is not intended to ensure equality of information among traders; rather, the focus is on providing everyone *equal access* to material information.⁴⁰ The securities laws are not violated by a mere asymmetry of information between trading partners. Some individuals may be at an informational advantage by having access to nonpublic, albeit nonmaterial, information, while other traders may achieve higher returns based on their own superior ability to piece together public information. In either scenario, the law does not impose an abstain-or-disclose obligation on such individuals despite the fact that they have more information than other traders in the market.

Instead, insider trading law advocates that all investors trading in the marketplace have relatively equal access to important informa-

tion.⁴¹ The registration requirements in the Securities Act of 1933 (1933 Act) and the disclosure requirements in the 1934 Act, and Sarbanes-Oxley Act of 2002 (SOX) facilitates the goal of providing everyone with equal access to relevant information regarding securities. Accordingly, there is an expectation that insiders will communicate functional information to others in the marketplace.⁴² The Second Circuit in *Texas Gulf Sulphur* noted that “inequities based upon unequal access to knowledge should not be shrugged off as inevitable in our way of life, or, in view of the congressional concern in the area, remain uncorrected.”⁴³

Q 1.9 Are there critics of the prohibition against insider trading?

Insider trading is a frequently discussed area of securities law that invites not only proponents but also opponents of the prohibitions. The policies underpinning insider trading law are not universally accepted.

One well-regarded commentator seeks to refute the market integrity justification by arguing that the SEC rules do not level the playing field for all investors,⁴⁴ that there will never be a level playing field because market professionals will always tilt the information in their favor,⁴⁵ and that outsiders are not disadvantaged by insider trading because the stock price absorbs the risk.⁴⁶

Other critics claim that insider trading is not contrary to notions of fairness, because insider trading allows both insiders and outsiders alike to profit.⁴⁷ In addition, one critic acknowledged the fact that the securities markets in countries that do not prohibit insider trading receive far higher liquidity and price-to-earnings ratios than corporate stock traded on the New York Stock Exchange.⁴⁸ Thus, Professor Jonathan Macey has pointed to the Japanese capital market as showing no signs that investors have low confidence in the securities market even though insider trading is commonplace and accepted.⁴⁹

Q 1.9.1 What are the arguments against prohibiting insider trading?

One of the main arguments against prohibiting insider trading is that there is no evidence insider trading causes any serious harm.

Scholars posit that if insiders were allowed to use confidential corporate information, the marketplace would benefit. It is argued that if firm managers were permitted to trade on material nonpublic information, the corporation's wealth would grow and consequently its stock value would increase to the benefit of all investors.⁵⁰ Moreover, trading on inside information arguably enhances marketplace efficiency because it increases the accuracy of the prices of securities and reduces price fluctuations that may lead to windfall gains.⁵¹

Another argument against prohibiting insider trading is that insider trading is a valuable form of managerial compensation. If managers were allowed to base part of their compensation on insider trading, there would be greater development of valuable information, investment in human capital, and more profitable yet riskier investment projects for the corporation.⁵²

Deregulators also contend that public regulation of insider trading is unnecessary and it should be permissible for corporations to privately control insider trading by contracting property rights in valuable information.⁵³ In other words, if insider trading is efficient for the firm, then shareholders would allow it, and the government should acquiesce in that decision.⁵⁴ Alongside this argument, it has been proposed that the law should be structured to give people the incentive to use their resources efficiently. Insider trading laws do just the opposite, according to critics: By prohibiting insiders from capitalizing on internal information, such laws discourage innovation.⁵⁵ According to one scholar, firms will bear the costs associated with creating information and share it with the marketplace, but only if they are able to exploit its benefits as well.⁵⁶ Mandatory disclosure of information reduces the value of the information and thus the motivation to produce it. On this view, insider trading can and should be controlled by private enforcement mechanisms available between contracting parties.

Q 1.10 How does insider trading negatively affect the marketplace?

One of the principal arguments against insider trading is that it reduces investor confidence in the marketplace, which in turn decreases capital investment and causes an illiquid economy. Said another way, insiders who trade on the basis of material nonpublic information will discourage other investors from venturing into the

market, causing a reduction in demand for securities and an increase in the cost of selling securities.⁵⁷ But studies have suggested that the effect of insider trading on supply and demand for the security has only a minimal impact on the price.⁵⁸

Q 1.11 Does insider trading have any positive effects on the marketplace?

It has been argued that insider trading reduces losses for outside investors after the nonpublic information is disclosed to the public.⁵⁹ One scholar hypothesizes that if insider trading were allowed, insiders could use material nonpublic information to trade on stock that they know will decline in value after the announcement of the information. Such trading activity will consequentially cause the stock price to fall. New purchasers of the stock who bought shares between the time the adverse news was heard by insiders and the public announcement will suffer fewer losses than if insider trading is forbidden and the stock maintained a higher price and plummeted after the news became public.⁶⁰

It has also been argued that insider trading enhances the accuracy of market prices for securities because allowing insiders to trade on confidential information causes the affected security to trade closer to its actual value, which is the price the security would trade at on the open market had the information been publicly available. In theory, such trading benefits society by “improving the economy’s allocation of capital investment and decreasing the volatility of security prices,”⁶¹ attracting additional risk-averse investors, and creating a more informative investing environment. The theory is that even nonpublic information gets priced into the securities trading price when insiders are not prohibited from trading during periods when they—but not the market—know material nonpublic information about the company.

Evolution and Expansion of the Law

Q 1.12 What are the origins of the prohibition against insider trading?

Insider trading liability originates from the antifraud provisions of the securities laws and SEC rules as well as case law. Section 10(b)

and Rule 10b-5 have been the primary statutory and regulatory basis for prohibiting insider trading, and it is interpretation of these provisions that has given rise to the development and evolution of insider trading law.

The Supreme Court's interpretation of these provisions in *Chiarella v. United States* established insider trading liability as rooted in section 10(b) and Rule 10b-5.⁶² In *Chiarella*, the Court interpreted section 10(b) of the 1934 Act as a catchall antifraud provision which prohibited insider trading.⁶³ In that case, the Court cautioned that a person with material nonpublic information has a duty to either abstain from trading or to disclose the information only if he or she is a fiduciary of the corporation.⁶⁴ In doing so, the Court emphasized that mere possession of material nonpublic information does not give rise to an abstain-or-disclose obligation under section 10(b) and Rule 10b-5.⁶⁵ Rather, a person who trades on the basis of material nonpublic information is liable under the insider trading provisions only if such trading breaches an existing fiduciary duty.⁶⁶

In reaching its holding, the Supreme Court relied heavily on *In re Cady, Roberts & Co.*, in which the SEC set forth the abstain-or-disclose obligation.⁶⁷ The obligation is not confined to the obvious class of corporate insiders (officers, directors, and controlling shareholders), but rather extends to other individuals who have a special relationship with a corporation and/or its insiders.⁶⁸ The obligation is premised on two elements. First, a person who by virtue of his or her position has access, directly or indirectly, to material nonpublic information that is intended solely for corporate purposes should not personally benefit from its use. Second, it is inherently unfair for such a person to take advantage of such information by trading in securities with uninformed investors.⁶⁹

Post-*Chiarella*, the Supreme Court further expanded the scope of insider trading liability in the landmark cases of *Dirks v. SEC*,⁷⁰ wherein tipper-tippee liability was further developed, and *United States v. O'Hagan*,⁷¹ in which the "misappropriation theory" as a basis for section 10(b) liability was validated. These developments are discussed in further detail in chapters 8 and 9.

Q 1.13 Under what statutes is insider trading prohibited?

The 1933 Act governs the initial registration of securities that are intended to be bought or sold by the public. The registration requirement was designed to provide investors with adequate information about the securities offered to the public with which to make an informed decision about whether or not to buy or sell those securities and to prohibit fraudulent misrepresentations and improper trade practices in the securities market.⁷² The 1933 Act also contains an antifraud provision, but as noted in Q 2.3, that provision has been of only limited relevance in insider trading cases.

The 1934 Act governs the regulation of securities after the point of their initial registration. The 1934 Act, *inter alia*, prohibits insider trading⁷³ and grants the SEC authority to promulgate implementing regulations.⁷⁴ The principal provisions of the securities laws that have been interpreted as prohibiting insider trading under the 1934 Act are section 10(b), which proscribes the use of “any manipulative or deceptive device or contrivance” within the scope of a securities transaction,⁷⁵ and section 14(e), which prohibits insider trading relating to tender offers.⁷⁶ SEC Rules 10b-5, 10b5-1, 10b5-2, and 14e-3 further define the parameters of insider trading.⁷⁷

The Insider Trading Sanctions Act of 1984 (ITSA) and the Insider Trading and Securities Fraud Enforcement Act of 1988 (ITSFEA) were enacted after mounting public concern over insider trading. Congress determined that it was appropriate to increase criminal and civil penalties for insider trading violations. In relevant part, ITSA authorizes the SEC to seek monetary damages of up to three times the profits gained or losses avoided due to insider trading or tipping.⁷⁸ The recoveries obtained in cases brought by the SEC under ITSA are paid into the U.S. Treasury and do not affect a plaintiff’s ability to pursue a private action under the 1934 Act. ITSFEA further enhanced the civil sanctions available to the SEC, added an express private right of action for contemporaneous trading,⁷⁹ and imposed stricter requirements for those who employ or control insider traders or tipplers.⁸⁰ The civil sanctions that may be imposed under ITSFEA depend on the court’s review of the facts and circumstances in the particular case, but in any event may not exceed three times the profits gained or losses avoided by the illegal conduct.⁸¹

The Private Securities Litigation Reform Act of 1995 (PSLRA)⁸² was designed to control private actions under the 1934 Act. While the PSLRA does not specifically address insider trading, it has affected insider trading cases. The PSLRA amended section 20 of the 1934 Act to bar the payment of attorney's fees or expenses incurred by private parties out of disgorgement funds created by an SEC action.⁸³ It also heightened pleading requirements for private actions and instituted an automatic stay of discovery pending determination of a motion to dismiss.⁸⁴

SOX is another statute worth mentioning here, although it does not specifically address insider trading. SOX was designed to improve the SEC's detection of securities law violations. It increased the resources and enforcement authority available to the SEC, imposed new responsibilities on public corporations, added new criminal statutes for securities fraud, and extended the statute of limitations for initiating a private right of action for securities law violations.⁸⁵

Q 1.14 How did insider trading law get broadened from corporate officers and directors to also include temporary insiders?

The case law has made clear that insider trading is not limited to insiders but is a flexible concept that is intended to have broad application.⁸⁶ The SEC in *In re Cady, Roberts & Co.* explained that the term "insider" is not limited to officers, directors, and controlling shareholders but includes other individuals who also may be subject to the duty to abstain from trading or disclose the information to the marketplace.⁸⁷ Insider trading laws, according to the SEC, are directed at any person who has a special relationship with the corporation.⁸⁸ The Second Circuit agreed with the SEC's position, coining the term "temporary insiders" in *SEC v. Lund* to refer to persons who are not corporate insiders per se but who merit the term by virtue of their special relationship with the corporation.⁸⁹

The Supreme Court endorsed the concept of temporary insiders in a famous footnote in *Dirks*.⁹⁰ The Court recognized that under certain circumstances, a fiduciary relationship may arise between a corporation and individuals who legitimately are given access to inside information solely for corporate purposes.⁹¹ For such a fiduciary duty to arise, there also must be a mutual understanding between the parties that nonpublic information will remain confiden-

tial.⁹² Accordingly, the Supreme Court recognized such individuals as temporary insiders who acquire the same fiduciary duties as classic insiders and fall within the ambit of section 10(b) for insider trading liability.

Q 1.15 How did the courts broaden insider trading liability to include tipplers and tippees?

Tippling is the passing along of material nonpublic information to others who then trade based on that information. The recipient of a tip is the “tippee” and the person who transmitted the information is the “tipper.”

Both the tippee and tipper may be subject to liability for insider trading where the tippee trades, even if the tipper does not. Section 10(b) and Rule 10b-5 have been construed broadly by the courts to extend liability to *any* deceptive device or contrivance used “in connection with the purchase or sale of any security.”⁹³ Tippling falls within such prohibited deceptive conduct.⁹⁴

The Supreme Court in *Chiarella* characterized a tippee as a “participant after the fact” in breach of a fiduciary duty that arose between the tippee and the source of the information, and thus potentially liable under the securities laws.⁹⁵ The Court reaffirmed this principle in *Dirks*.

Q 1.15.1 What is the test for whether a tipper is liable for insider trading?

An insider owes a fiduciary duty to the corporation and its shareholders to safeguard material nonpublic information from outsiders. An insider could be found liable under section 10(b) and Rule 10b-5 as a tipper where the person reveals material nonpublic information to an outsider for an improper purpose. If an insider “tips off” an outsider without a legitimate business justification for doing so and the tippee then trades “on the basis of” that information, the tipper has breached his or her fiduciary duty owed to the corporation and its shareholders.⁹⁶

Thus, the tipper is liable for the improper securities transactions made by the tippee on the basis of the tip.⁹⁷ Tipplers are held jointly and severally liable for the profits gained or losses avoided by their tippees.⁹⁸ Tipper liability is considered a necessary component of

insider trading liability, because it deters a fiduciary from attempting to do indirectly through a tippee what he or she may not do directly.⁹⁹

Q 1.15.2 What is the test for whether a tippee is liable for insider trading?

A tippee is not a corporate insider or a temporary insider for section 10(b) and Rule 10b-5 purposes. However, a person can be found liable for insider trading as a tippee where (1) the person received a tip in breach of an insider-tipper's fiduciary duty (which incorporates the "personal benefit" requirement); (2) the person knew or should have known that there was a breach of a duty by the insider; and (3) the person uses the tip to trade securities.¹⁰⁰

Under the first element, whether an insider-tipper breaches a fiduciary duty in disclosing material nonpublic information depends largely on the purpose of the particular disclosure.¹⁰¹ In *Dirks*, the Supreme Court held that a breach occurs when the insider stands to benefit, directly or indirectly, on account of the disclosure.¹⁰² Absent any personal benefit (pecuniary, relational, reputational, or otherwise) to the insider, there is no breach of duty to the corporation and therefore no derivative breach by the person who receives the tip.¹⁰³ But since *Dirks*, courts have read the "personal benefit" requirement very broadly and find that test met in virtually every case.¹⁰⁴

The second element is a scienter element, which requires evidence that the tippee knew or should have known that the information received was in breach of the insider's duty to the corporation. If the above test is met, then the tippee has an affirmative duty, derived from the insider-tipper's fiduciary duty, to abstain from trading on the tip or to disclose it to the marketplace.¹⁰⁵

Q 1.16 What is the "misappropriation theory" of insider trading?

The misappropriation theory is an independent and separate theory of liability from the classical theory of insider trading. It prohibits a person or entity from trading based on information which has been misappropriated from the source of the information, even if the information has not been misappropriated from the issuer whose securities are then traded. As such, the misappropriation theory is much broader than the classical theory in that it does not require a

breach of fiduciary duty by a corporate insider. This theory fits within the contours of section 10(b) and Rule 10b-5 because the information which has been misappropriated is being used deceptively “in connection with the purchase or sale of a security.”¹⁰⁶

Liability under the misappropriation theory requires a duty of trust or confidence, which includes, but is not limited to, a fiduciary relationship between the “misappropriator” and the source of the misappropriated information. The misappropriation theory applies whenever there is a mutual expectation of trust and confidence running from the source of the information to the alleged wrongdoer.¹⁰⁷ Under those circumstances, the source of the information may justifiably rely on the recipient to safeguard secret communications. The Supreme Court in *O’Hagan* described the fraud underlying the misappropriation theory as “feigning fidelity” to the source of information.¹⁰⁸

Although the duty of trust or confidence which gives rise to possible insider trading liability under the misappropriation theory is intended to be expansive, the SEC has provided helpful guidance in Rule 10b5-2. It provides three broad examples of circumstances which give rise to a duty of trust or confidence to the source of the information obtained for purposes of the misappropriation theory. Thus, under Rule 10b5-2, a person has a duty of trust or confidence to the source of the information obtained whenever

- (1) that person agrees to keep the information confidential;
- (2) there is a history, pattern, or practice of sharing confidences between the person communicating the information and the person to whom it is communicated, such that there is a mutual expectation of confidentiality; or
- (3) the person receives or obtains confidential information from his or her spouse, parent, child, or sibling.¹⁰⁹

In the third situation, the recipient can establish that no duty existed by showing that he or she neither knew nor reasonably should have known that the source of the information expected that the information would remain confidential.¹¹⁰ It is important to remember—as the preliminary note to Rule 10b5-2 makes clear—that the examples provided are nonexclusive.

Once a duty of trust or confidence is established, a breach occurs whenever information obtained from the source is misused or

improperly acquired by the party who then trades based upon the misappropriated information. Thus, the misappropriation theory prevents the recipient of the information, while in possession of confidential information, from using it to trade *secretly* in securities and gain a personal advantage in the marketplace.¹¹¹ If, however, a recipient reveals his or her intent to trade on the information to the source of the information and obtains the source's approval to do so, there is no misappropriation and, therefore, no insider trading liability under the misappropriation theory.¹¹²

Because of its breadth, the misappropriation theory exposes a broad range of individuals, including corporate outsiders and tippees, to potential liability even if neither the trader nor the source of the information owes any fiduciary or other duty to the issuer or its shareholders.¹¹³

Q 1.16.1 What are the policies underlying the misappropriation theory?

The policies underlying the misappropriation theory comport with the purpose of the securities laws in protecting the marketplace, corporations, and the investing public from “misappropriators” who may steal confidential information and use it to gain an unfair advantage in the market.¹¹⁴ The overarching policy is to safeguard existing fiduciary and confidential relationships and ensure that a person owing duties of trust or confidence to another does not breach them.¹¹⁵ As previously noted, the judicial interpretation of the theory extends liability to outsiders who would not normally come within the ambit of section 10(b) and Rule 10b-5, recognizing the need to prevent all individuals from misappropriating information to the detriment of investors and marketplace stability.

Q 1.16.2 Has there been criticism of the misappropriation theory?

Although the misappropriation theory is universally accepted by courts and regulators throughout the United States, it is not without critics. Critics have argued that the theory is inconsistent with the plain language of Rule 10b-5. Misappropriation is not the type of conduct that can be classified as fraud; as a general legal theory, the misappropriation theory rather has been applied to a simple breach of contract, a breach of a doctor-patient relationship, or a failure to

keep family confidences.¹¹⁶ Other critics have argued that the misappropriation theory is over-inclusive and casts too wide a net.

Commentators have also argued that the misappropriation theory creates loopholes in the insider trading laws. First, the theory is said not to cover “the brazen fiduciary” who discloses to his principal his intent to use the information for personal benefit.¹¹⁷ Second, the theory does not encompass the situations where the principal authorizes the use of the confidential information by the recipient. Such critics generally feel that the misappropriation theory does not go far enough in protecting investors and the market.¹¹⁸

Q 1.16.3 What is the SEC’s view of the misappropriation theory?

The SEC endorses the misappropriation theory as a basis of liability for insider trading. Before the Supreme Court’s adoption of the misappropriation theory in *O’Hagan*, the SEC advocated its applicability in the lower courts. Thus, for example, the SEC submitted an amicus curiae brief in *United States v. Winans*,¹¹⁹ in which the Second Circuit affirmed the use of the misappropriation theory, finding the defendant guilty of misappropriating valuable information from his employer and using it for personal advantage in the market.¹²⁰

Ten years later, the SEC continued to support adoption of the misappropriation theory by filing an amicus curiae brief in the rehearing of *O’Hagan* in the Eighth Circuit. There, the SEC asserted that the misappropriation theory was a “linchpin” in its enforcement of insider trading laws, and rejection of the theory would “substantially cripple” its efforts to protect investors and the marketplace.¹²¹

In 2000, the SEC supported the misappropriation theory by broadening it through the adoption of Rule 10b5-2, which, as discussed in Q 1.16, provides a nonexclusive list of relationships that give rise to “duties of trust and confidence” for purposes of the misappropriation theory.¹²²

Notes

* Stacy Ma, an associate in Schulte Roth & Zabel's Litigation Group, assisted in the preparation of this chapter.

1. 15 U.S.C. § 78j; 17 C.F.R. § 240.10b-5.
2. 15 U.S.C. § 77b(a)(1).
3. *Id.*; see also chapter 4.
4. 17 C.F.R. § 240.10b5-1(b); see also chapter 5.
5. *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976) (articulating the test for “materiality” in the context of § 14(a) cases); see also chapter 6.
6. *TSC Indus.*, 426 U.S. at 448–49 (1976); *Basic Inc. v. Levinson*, 485 U.S. 224, 232 (1988) (adopting the materiality standard for section 10(b) and Rule 10b-5 violations as outlined in *TSC Industries*); *United States v. Anderson*, 533 F.3d 623 (8th Cir. 2008) (internal company reports found sufficiently material for purposes of section 10(b)).
7. *TSC Indus.*, 426 U.S. at 449.
8. Selective Disclosure and Insider Trading, Securities Act Release No. 7881, Exchange Act Release No. 43,154, Investment Company Act Release No. 24,599, 2000 WL 1201556, at *10 (Aug. 15, 2000) [hereinafter Selective Disclosure and Insider Trading, Securities Act Release No. 7881, 2000 WL 1201556].
9. *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 854 (2d Cir. 1968); see chapter 7.
10. See *id.* at 853.
11. *In re Cady, Roberts & Co.*, Exchange Act Release No. 6668, 40 S.E.C. 907, 911, 1961 WL 60638 (1961); see chapter 6.
12. *Texas Gulf Sulphur Co.*, 401 F.2d at 848; *In re Cady, Roberts & Co.*, Exchange Act Release No. 6668, 40 S.E.C. at 911.
13. *In re Cady, Roberts & Co.*, Exchange Act Release No. 6668, 40 S.E.C. at 911.
14. *Texas Gulf Sulphur Co.*, 401 F.2d at 848.
15. *In re Cady, Roberts & Co.*, Exchange Act Release No. 6668, 40 S.E.C. at 911; *Dirks v. SEC*, 463 U.S. 646, 655 n.14 (1983); *Texas Gulf Sulphur Co.*, 401 F.2d at 848; see *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 495 F.2d 228 (2d Cir. 1974).
16. 15 U.S.C. § 76j(b); *Chiarella v. United States*, 445 U.S. 222, 230 n.12 (1980); see, e.g., *Dirks*, 463 U.S. 646; *In re Investors Management Co.*, Exchange Act Release No. 9267, 44 S.E.C. 633, 639, 1971 WL 120502 (July, 29 1971); see also chapter 10.
17. *United States v. O'Hagan*, 521 U.S. 642, 653–54 (1997) (endorsing the misappropriation theory of insider trading and imposing criminal liability on an attorney for misappropriating a client's confidential information about forthcoming tender offer and using it for his own personal trading).

18. 15 U.S.C. § 78j(b); 15 U.S.C. § 77; *Dirks*, 463 U.S. at 655; *Shapiro*, 495 F.2d at 237.
19. 15 U.S.C. § 78t(b); *Dirks*, 463 U.S. 646; *see also* chapter 10.
20. 15 U.S.C. § 78u-1.
21. 15 U.S.C. § 78t-1 (establishing private right of action for contemporaneous traders); 15 U.S.C. § 78p (establishing private right of action to recover short-swing trading).
22. 15 U.S.C. § 78ff.
23. *Id.*; U.S. Sentencing Guidelines Manual § 2B1.4 (2000).
24. Mandatory Victims Restitution Act of 1996, Pub. L. No. 104-132, 110 Stat. 1214 (1996) (codified in relevant parts at 18 U.S.C. §§ 3663A, 3664).
25. 15 U.S.C. § 78u-1(a)(2).
26. *Id.* (monetary penalty is in addition to the disgorgement of actual profits or injunctive relief).
27. 15 U.S.C. § 78u-4.
28. *E.g.*, SEC v. Unified SAL, 910 F.2d 1028 (2d Cir. 1990) (upholding lower court's ordering of an asset freeze even where SEC is not entitled to a preliminary injunction).
29. *E.g.*, *Harmsen v. Smith*, 693 F.2d 932, 948 (9th Cir. 1982) (upholding jury's award of punitive damages).
30. 15 U.S.C. § 78t-1.
31. 15 U.S.C. § 78b (discussing the necessity for regulation of the securities exchange and markets).
32. *United States v. O'Hagan*, 521 U.S. 642, 652 (1997).
33. WILLAM K.S. WANG & MARC I. STEINBERG, *INSIDER TRADING* § 2:3.1, at 2-27 (2008).
34. *Id.* at 2-30.
35. *O'Hagan*, 521 U.S. at 658.
36. *Dirks v. SEC*, 463 U.S. 646, 662-64 (1983).
37. Alexandre Padilla, *How Do We Think About Insider Trading? An Economist's Perspective on the Insider Trading Debate and its Impact*, 4 J.L. ECON. & POL'Y 239, 251 (2008) (arguing that moral justifications for prohibiting insider trading are present in the regulatory discourse).
38. *Id.*
39. *See generally* Alan Strudler & Eric W. Orts, *Moral Principle in the Law of Insider Trading*, 78 TEX. L. REV. 375 (1999).
40. *Dirks*, 463 U.S. at 657; *Chiarella v. United States*, 445 U.S. 222, 233-34 (1980) (clarifying that neither Congress nor the SEC enacted a "parity-of-information" rule).
41. SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 848 (2d Cir. 1968).
42. *Chiarella*, 445 U.S. at 233-34.
43. *Texas Gulf Sulphur Co.*, 401 F.2d at 852.
44. Jonathan R. Macey, *From Judicial Solutions to Political Solutions: The New, New Direction of the Rules Against Insider Trading*, 39 ALA. L. REV. 355, 378 (1988) (referencing the information advantage tender offerors have over their trading partners and certain purchasing rights regulated under the Williams Act).

45. *Id.* (arguing that some investors want insiders banned, not to level the playing field, but to optimize the investors' own strategic, nondiversified trading).
46. *Id.* (positing that outsiders purchase stock on a price that reflects the risk that insider trading may occur).
47. Dennis W. Carlton & Daniel R. Fischel, *The Regulation of Insider Trading*, 35 STAN. L. REV. 857, 881–82 (1983).
48. Macey, *supra* note 44, at 378–79.
49. *Id.*
50. Carlton & Fischel, *supra* note 47, at 881–82.
51. Stephen Bainbridge, *The Insider Trading Prohibition: Legal and Economic Engima*, 38 FLA. L. REV. 35, 42 (1986).
52. Carlton & Fischel, *supra* note 47, at 871–72 (suggesting that insider trading is beneficial as a way for managers to self-tailor compensation packages by trading on new information, increasing the development of valuable innovations).
53. *Id.*
54. Bainbridge, *supra* note 51, at 42.
55. Jonathan R. Macey, *From Fairness to Contract: The New Direction of the Rules Against Insider Trading*, 13 HOFSTRA L. REV. 9, 31–32 (1984).
56. *Id.*
57. *Id.* at 21 n.55 (discussing the “efficient market hypothesis”).
58. Bainbridge, *supra* note 51, at 45.
59. HENRY MANNE, INSIDER TRADING AND THE STOCK MARKET 77-100 (1966).
60. *Id.*
61. Bainbridge, *supra* note 51, at 42.
62. *Chiarella v. United States*, 445 U.S. 222 (1980).
63. *Id.* at 234–35.
64. *Id.* at 228.
65. *Id.* at 235.
66. *Id.* at 230.
67. *In re Cady, Roberts & Co.*, Exchange Act Release No. 6668, 40 S.E.C. 907, 911, 1961 WL 60638 (1961); *Chiarella*, 445 U.S. at 227.
68. *Cady, Roberts & Co.*, 40 S.E.C. at 911.
69. *Id.*
70. *Dirks v. SEC*, 463 U.S. 646 (1983).
71. *United States v. O'Hagan*, 521 U.S. 642 (1997).
72. 15 U.S.C. § 77aa.
73. 17 C.F.R. § 240.10b-5; 17 C.F.R. § 240.10b-5.
74. 17 C.F.R. § 200.2.
75. Securities Exchange Act of 1934, 15 U.S.C. § 77j(b). Section 10(b) in pertinent part provides:

It shall be unlawful for any person, directly or indirectly. . .

- (b) [t]o use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered . . . any manipulative or deceptive device or

contrivance in contravention of such rules or regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

76. 15 U.S.C. § 78n.
77. 17 C.F.R. § 240.10b-5. SEC Rule 10b-5 is particularly important for challenging insider trading activity. In pertinent part it provides:
 - [i]t shall be unlawful any person, directly or indirectly. . .
 - (a) to employ any device, scheme, or artifice to defraud,
 - (b) to make any untrue statement of material fact or omit to state a material fact . . .
 - (c) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.
78. 15 U.S.C. § 78u-1.
79. 15 U.S.C. § 78t-1 (governing private rights of action based on contemporaneous trading).
80. 15 U.S.C. § 78t(a). ITSFEA is codified as section 20A of the Exchange Act, establishing a basis for liability for any person who, directly or indirectly, controls any other person found liable under the Exchange Act or the SEC rules promulgated thereunder. A showing of good faith conduct may exempt the controlling person from liability.
81. 15 U.S.C. § 78u-1(a)(2).
82. 15 U.S.C. § 77z-1.
83. 15 U.S.C. § 78t.
84. 15 U.S.C. § 78u-4(b)(1)–(2).
85. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002).
86. SEC v. Lund, 570 F. Supp. 1397, 1402 (2d Cir. 1983) (classifying a business associate and long-time friend of an insider as a “temporary insider”).
87. *In re Cady, Roberts & Co.*, Exchange Act Release No. 6668, 40 S.E.C. 907, 911, 1961 WL 60638 (1961).
88. *Id.*
89. *Lund*, 570 F. Supp. at 1403 (citing *Dirks v. SEC*, 463 U.S. 646, 655 n.14 (1983)); *Feldman v. Simkins Indus., Inc.*, 679 F.2d 1299, 1304 (9th Cir. 1982).
90. *Dirks*, 463 U.S. at 655 n.14.
91. *Id.* (establishing that underwriters, accountants, lawyers, or consultants may become fiduciaries of shareholders by entering into a confidential and business relationship with the corporation).
92. *Id.*
93. 15 U.S.C. § 78j; 17 C.F.R. §240.10b-5; *Dirks*, 463 U.S. 646.
94. *Dirks*, 463 U.S. 646; *see also* chapter 10.
95. *Chiarella v. United States*, 445 U.S. 222, 230 n.12 (1980).
96. *Dirks*, 463 U.S. at 663–64.
97. *Id.*; *but see* *United States v. Evans*, 486 F.3d 315 (8th Cir. 2007) (acquittal of a tipper does not foreclose prosecution of the tippee).
98. 15 U.S.C. § 78t(a).

99. *Dirks*, 463 U.S. at 659.
100. *See generally id.*
101. *Id.* at 662–64.
102. *Id.*
103. *Id.*
104. *See, e.g.*, SEC v. Rubin, 91 Civ. 6531, 1993 U.S. Dist. LEXIS 13301, at *12–13 (S.D.N.Y. Sept. 23, 1993) (assuming a personal benefit to the tipper absent contrary evidence); SEC v. Downe, 969 F. Supp. 149, 156 (S.D.N.Y. 1997), *aff'd sub nom.* SEC v. Warde, 151 F.3d 42, 48 (2d Cir. 1998) (evidence of specific or tangible benefits is not required to pass “personal benefit” test, only an intent on the part of the tipper to benefit or give a “gift” of information to the tippee).
105. *Dirks*, 463 U.S. at 659–60.
106. 15 U.S.C. § 78j; Chiarella v. United States, 445 U.S. 222, 245 (1980); United States v. O'Hagan, 521 U.S. 642, 652 (1997); *see* United States v. Newman, 664 F.2d 12, 18 (2d Cir. 1981).
107. 17 C.F.R. § 240.10b5-2(b)(1) (codifying the SEC's approach to fiduciary relationships whereby there must be an express or implied assent by the recipient to accept the fiduciary duty).
108. *O'Hagan*, 521 U.S. at 655.
109. 17 C.F.R. § 240.10b5-2(b)(1)–(3).
110. 17 C.F.R. § 240.10b5-2(b)(3).
111. *O'Hagan*, 521 U.S. at 652.
112. *Id.* at 655.
113. *Id.* at 653; *e.g.*, United States v. Chestman, 903 F.2d 75 (2d Cir. 1990); SEC v. Tome, 638 F. Supp. 596 (S.D.N.Y. 1986) (using the analytical framework in *Dirks* as a basis for imposing tipper-tippee liability under the misappropriation theory).
114. *O'Hagan*, 521 U.S. at 656.
115. *See generally id.* (validating the misappropriation theory as a basis for liability and emphasizing the importance of fiduciary relationships).
116. *See, e.g.*, Michael P. Kenny & Teresa D. Thebaut, *Misguided Statutory Construction to Cover the Corporate Universe: The Misappropriation Theory of Section 10(b)*, 59 ALB. L. REV. 139, 143 (1995) (discussing the development of the misappropriation theory by the courts expansive interpretation of section 10(b)).
117. *See* Donna M. Nagy, *Reframing the Misappropriation Theory of Insider Trading Liability: A Post O'Hagan Suggestion*, 59 OHIO ST. L.J. 1223, 1257–58 (1998).
118. *See id.* at 1250, 1256–58; Roberta S. Karmel, *Outsider Trading on Confidential Information—A Breach in Search of Duty*, 20 CARDOZO L. REV. 83, 95 n.8 (1998).
119. United States v. Winans, 612 F. Supp. 827 (S.D.N.Y. 1985), *aff'd in part, rev'd in part sub nom.* United States v. Carpenter, 791 F.2d 1024 (2d Cir. 1986) (affirming the insider trading charge and reversing the conspiracy charge against Winans).
120. *Carpenter*, 791 F.2d at 1026, 1028–30 (describing the type of information misappropriated as market-sensitive confidential information, and the nature and timing of Winans' *Wall Street Journal* column “Heard on the Street,” which featured stock analysis and prospects). Winans would tip outsiders on securities-related information that was scheduled to appear in the column in advance of its publica-

tion. This scheme allowed Winans and his tippees to obtain substantial pecuniary gains.

121. Brief for SEC as Amicus Curiae Supporting Petitioners, *United States v. James Herman O'Hagan* (8th Cir. 1996) (Nos. 94-3714 and 94-3856), *available at* www.sec.gov/news/extra/ohaganbr.txt.

122. 17 C.F.R. § 240.10b5-2.

