**BUL4310 READINGS FOR INDIVIDUAL ASSIGNMENT #3**

# SECURITIES LAW AND INSIDER TRADING

## A: READING CONTENT

Table of Contents for this Document


Introduction ........................................................................1
Online Trading of Securities ............................................1
State "Blue Sky" Laws ......................................................1
The Federal Government's
Approach to Securities Regulation ....................................1
What Is a Security? ...........................................................2
Securities Act (1933) Particulars .......................................2
Securities Exchange Act (1934) Particulars ......................3
Comparison to Germany New Rule 206 ...........................5
Statute 10-b (1934 Act) & SEC Rule 10-b-5:
Who has standing to sue? .................................................5
Statute of Limitations. .........................................................5
The Private Securities Litigation Reform Act .....................6
Insider Trading....................................................................7


### Introduction

One of the methods for raising the capital needed for a corporation or partnership is to sell interests in the corporation or partnership. Corporations sell shares, and partnerships sell limited partnership interests. Investors provide the capital these businesses need to operate. They give the businesses their money to work with and in return are given an interest in the business. The investors' hope is that the business will give them a profit on their investment (dividends) and that the value of their investment will grow as the business increases in value. The investment arrangement in theory is mutually beneficial. However, because people are so eager to have their money grow and because businesses need money, the interests of business and investors are so often at odds that there seems to be an inherent conflict of interest n the investment relationship. Because of this conflict, there are laws regulating investments at both state ad federal levels. These laws are called securities laws, and they govern everything from sales of securities to soliciting proxies from owners of securities.

### Online Trading of Securities

On November 22, 1999, after almost ten months of work, the SEC issued a 100-page report about online trading. It noted that online stock trading firms could have a legal responsibility, in some cases, to make sure investments made by their customers are "suitable" for them. New York State attorney general's report on that same day focused on the technical glitches and systems—capacity problems continuing to plague many web brokers. The SEC report's recommendations could require new rules from industry regulators: requiring web brokers to give more information about technical problems such as website outages, to test regularly their computer systems, and to set up contingency plans for breakdowns, and to have "market centers" (e.g., stock exchanges) give web brokers better information about stock prices and market conditioning (so that brokers can route orders to the best execution points).

### State "Blue Sky" Laws

Blue Sky laws are state securities laws. The Florida Securities and Investor Protection Act (Florida Statutes, Chapter 517), as revised in 1990, recognizes that Florida attracts investment scam artists because of its growing, mobile population and its large quantity of retirement funds. Registration of securities is required. Persons who offer or sell securities must register (to demonstrate a minimal level of knowledge and ability). Enforcement is via the Florida Department of Banking and Finance.

### The Federal Government's Approach to Securities Regulation

The federal government's approach to securities regulation is simply to require the disclosure of anything that would impair the soundness of a securities offering. As in many other states, the approach in Florida Blue-Sky Law is to go beyond mere disclosure requirements—the state tries to protect investors by actually reviewing the merits of a securities offering. The state thus tries to determine the offerings overall fairness.

New issuances of securities: a one-time disclosure before the distribution of new securities – the "Primary Market">>>>>> 1933 Securities Act-regulates the original distribution of securities (e.g. IPOs- Initial Public Offerings) –

“To provide full and fair disclosure of the character of securities sold in interstate and foreign commerce and through the mails, and to prevent frauds in the sale4s thereof.” Therefore the 1933 Securities Act requires registration with the SEC.

A University of California at Berkeley law professor has argued (with very little probability of success) that the marketplace should govern issuance and offerings and issuers – without governmental regulation – but that there should be regulation of investors. Depending on how well an investor does on some tests of his securities acumen, the investor may or may not be able to invest in a category of securities. Stephen Choi, “Regulating Investors Not Issuers: A Market-Based Proposal,” 88 CAL.L. REV. 279 (2000).

Previously-issued securities - the "Secondary Market" >>>>>> 1934 Securities Exchange Act – created SEC, regulates the trading of securities after the original distribution - "to prevent inequitable and unfair practices on [securities] exchanges and [over-the-counter] markets" Transactions involving existing shares.

The SEC ran into budget problems, enforcement hurdles, low morale, and other difficulties throughout the 1990s and into the early 21st Century. From 1991 to 2000 the SEC workload increase greatly outpaced the increase in staff in these areas – (1) Review of corporate filings – 60%, 29%; (2) Complaints and inquiries – 100%, 16%; (3) Market and firm supervision – 137%, 51%; (4) Review of investment company filings – 108%, 9%; (5) Investment company and adviser assets under management – 264%, 166%).

Information Disclosure Laws
The securities laws (both the 1933 Act and the 1934 Act) are information disclosure laws - to make available reliable information on publicly-offered securities. Nothing necessarily about the worth of the securities - the SEC does not guarantee anything.

“October: This is one of the peculiarly dangerous months to speculate stocks in. The others are July, January, September, April, November, May, March, June, December, August, and February.” —Mark Twain, *Pudd’nhead Wilson,*

“Wall Street has only two emotions: fear and greed.” Bill McGowan, MCI’s CEO.

New York mobster Lucky Luciano once spent a day at the stock exchange and concluded that he had “joined the wrong mob.”

**What is a Security?**
More than just stocks and bonds. Many devices qualify as securities, generally reflective of ownership in, or another interest in, a business. SEC v. W.J. Howey Co., 328 U.S. 293 (1946) – citrus grove interests

Howey and subsequent case law define a security as any arrangement where you put money into something you have no control over in hopes of a return. More specifically, the Four Elements of a Federally-Regulated Security are: A covered investment contract (a security) has been broadly defined as a "transaction or scheme whereby a person who (1) invests his money (2) in a common enterprise and (3) is led to expect profits (4) solely from the [entrepreneurial or managerial efforts of others].

”The fourth (last) standard, in brackets, is a refinement of the Howey test. It was endorsed in dicta in the U.S. Supreme Court case of United Housing Foundation v. Foreman, 421 U.S. 837 (1975).
The definition "embodies a flexible . . . principle . . . capable of adaptation to meet the countless and variable schemes devised by those who seek the use of money of others on the promise of profits."

**Securities Act (1933) particulars**

File a Registration Statement
Lining up Potential Buyers – only a few things are permitted before SEC approval of a registration – can sue for: negligence or fraud .

Tombstone Advertisements – a bare-bones ad identifying the security, its price, and the party to whom orders will be executed. So, it is a plain advertisement, with “just the facts” on a prospective securities issuance.

For “Sell” Initial Public Offering (IPO) shares on-line, final customer reconfirmation orders (where the customer actually becomes bound) must occur no earlier than 48 hours before the SEC officially declares an offering “effective” by the SEC. (Per a July 1999 SEC No-Action Letter to Wit Capital Group).

Query: do most securities purchasers read prospectuses? Or are prospectuses instead mainly tools for potential litigation, drafted by lawyers for other lawyers?

Section 11 - buyers of securities, whether as part of a public offering or in the secondary market, can sue a number of people for material misstatements in the registration statement (or prospectus): Section 11 covers everyone who signed it, including the main officers and the directors; every expert, e.g., accountants, who certified or prepared part of it (for that part certified or prepared); all underwriters involved in the distribution; all other "controlling" persons.

Via SEC rules issued in 2001, the SEC curtailed the type of work some auditors may be permitted to undertake (e.g., the limits are meant to restrict possible conflicts of interest). But the restrictions are far less onerous than was initially proposed.

And companies often simply swap auditors, when scandals arise. Looking at some companies with fired auditors - Adelphia, Allied Irish Banks, Computer Associates, Dollar General, PNC Financial Services, Valley National Bancorp, and Xerox – we see that each of the four major accounting firms – Deloitte &Touche, Ernst & Young, KPMG, and PriceWaterhouseCoopers – were fired by one or more of those companies and yet were hired by one or more of the other companies. LOST INDEPENDENCE AMONG AUDITORS is in the SELECTED READINGS (Reaction Paper Articles).

In late 2002, the SEC proposed rules to improve the timeliness and breadth of public companies’ financial reporting, including requiring top executives (CEOs and CFOs) to certify the accuracy of annual reports (to state, “to the best of their knowledge” the filings are correct and that they are an accurate picture of the company’s current conditions and prospects – fraud charges could be brought against executives who sign off on reports they know to be false);

**Securities Exchange Act (1934) particulars**

Creates the Securities and Exchange Commission (SEC)
This agency has one of the best reputations for competence and integrity of all of the many federal agencies. However, even it can somehow miss what, in retrospect, appears to have been rampant fraud, particularly if the offending party has a legitimate lawyer and a legitimate accounting firm.

From its outset, until the recent years of Enronesque scandals and of former chairman (August 2001 to November 2002) Harvey Pitt’s repeated miscues, the Securities and Exchange Commission (SEC) was viewed as perhaps the premier federal agency, with very capable and dedicated commissioners and staff. But critics, such as former commissioner Carter Beese, Jr., increasingly contend that the SEC lacks an accurate sense of the regulatory burdens it places on market participants; these costs, he claims, drive some capital, both foreign and domestic, to overseas markets instead of to American companies. Beese's proof includes figures on domestic and overseas investment >>> U.S. investors investing overseas: in 1984 - $30 Billion; and in 1994 - $855 Billion. (Moreover, the SEC has difficulty enforcing laws against everyone engaged in securities fraud, perhaps especially against those defrauding smaller investors. Example: William Brenner has repeatedly been found culpable for cheating small investors, yet he seems able to avoid any effective, permanent punishments.) Repeatedly, many critics attack from the other view: that the SEC is too cozy with the businesses it oversees.

While trading volume soared (about 580 million shares daily in 1994; to about 18 billion shares daily in 1999) and new public offerings soared (about 7,000 in 1994 and over 20,000 in 1999), the SEC's budget only rose about 10% altogether since 1995 (to about $330 million in 1999) and its enforcement case load actually decreased slightly (from about 500 cases in 1994 to 475 in 1999 to fewer thereafter). While trading volume and IPO levels dropped in 2001 and 2002, the need for SEC investigations and enforcement actions soared. Only in the aftermath of Enron and other scandals have any significant monies been allocated to SEC improvements.

Comparison to Germany:
Shareholder protection in Germany is still relatively new. Until 2002, the regulatory agency for Germany, the BAWe, was allowed to investigate insider trading, but not share-price manipulation. Furthermore, the BAWe was required to forward its insider-trading evidence to local courts, which – unlike American courts - often have lacked the competence for prosecution of such cases. In 2002, a new German law allowed the BAWe to issue fines in cases of share-price

manipulation and to hold publicly-listed companies liable for statements they make in official press releases. That is an exception to Germany's decentralized form of government for purposes of securities regulation.

Besides having a relatively weak financial regulatory agency, the German government lacks any specialized courts for hearing complex financial trials. In contrast, the SEC has the authority to bring such cases to civil courts or refer them to administrative law judges who have a specialty for dealing with such matters. The SEC also has a team of prosecutors for help on court cases, but the BAWe does not. Every power granted to the BAWe in the 2002 legislation is a power the SEC already has long held. Moreover, the BAWe still cannot fine insider-trading, while the SEC long has done so.

Regulates secondary markets (the markets after the initial issuance), and also broker-dealers and professionals (e.g., accountants and lawyers).[1]

The SEC, for example, may proceed against securities firms, investment bankers, or others for "spinning" – the practice of giving out shares to favored or potential clients in hopes of winning future business. (These securities professionals, by "spinning," unfairly favor themselves, their friends, and their future prospects over other, non-favored customers.) And, of course, the SEC – as with other federal regulators – can proceed against brokers, accountants, or others who make false statements; that is a federal crime punishable by as much as five years in prison.

If a broker told other clients that a major client of the broker was dumping certain stock, that would be an ethical violation for the broker. But there is no law expressly forbidding it, according to securities law expert John Coffee of Columbia Law School.

It is unlawful for Broker B to engage in "front-running": Telling other clients of B about the imminent sale of stock by C, another one of B's client's - i.e., telling these other clients before C's sale order is processed. Obviously, as with b, immediately above, the broker is trying to help clients sell their stock before the price drops. But with front-running the broker's client C is deemed "injured" by the broker's actions.

Permits (even encourages) Self-Regulation of the Industry and Internal Regulation (within a company) as long as that does not conflict with Federal statutes or rules

Sometimes the SEC works with "private" groups (e.g., the National Association of Securities Dealers (NASD) and the National Securities Clearing Corp.) to regulate professionals and markets, particularly smaller abuses not easily reached by limited government resources. - With the Internet, we are moving toward increased use of Electronic Communications Networks (ECNs) and away from old-fashioned stock exchanges. The future of securities regulation thus is quite uncertain.

A brokerage or other company may establish internal rules. For example, many brokerages – e.g., Merrill Lynch – have a policy that brokers cannot discuss a client's trades with another client. Even if it is not front-running (see above), and thus apparently not illegal, such discussions would be grounds for the brokerage's terminating the broker, requiring him to disgorge funds, and otherwise taking remedial actions.

Broker B could probably avoid such rules by simply suggesting to his/her clients that they should sell the stock of another of B's client's (client C), with B basing his/her recommendation on some general information about the market (not telling those other clients' that C was selling, or planning to sell, its stock).

The securities industry and its regulators must police the behavior of investment houses and their analysts. When a reputable firm allows its analysts to make recommendations that they know to be false, that is more serious than a simple conflict-of-interest. Research and advisory services are there to protect the investors, not to generate investment-banking fees. Any deviation must result in harsh punishment, both to the firm and to the analyst. The notion

---

[1] For example, on March 30, 2004, the Securities and Exchange Commission and the New York Stock Exchange (NYSE) announced that five NYSE specialist firms will pay $241.8 million to settle charges that they profited from illegal trading practices on the floor of the exchange. The firms had violated securities laws by executing their own orders for the shares they managed ahead of customers' orders. That deprived clients of fair trades and possibly better prices. Between 1999 and 2003, the five firms made more than $150 million. Of the total settlement, $154.088 million was to pay customers damaged by the firms' actions (disgorging the firms' $150 million-plus in profits). The rest of the money ($87.736 million) was for fines paid to the SEC and the NYSE. The five firms, without admitting or denying the charges, also will take steps to improve their regulatory compliance procedures and oversights.

that independent research firms cannot survive economically is not necessarily true. There are examples, such as Value Line, and the large institutional investors could certainly accelerate the process.

**New Rule 206**
New SEC Rule 206(4)-7 (requiring investment advisers to adopt programs to ensure compliance with the Investment Advisers Act of 1940) has worked a fundamental change in the SEC's regulatory approach toward professionals. In the past, the Commission was inclined to adopt, upon the demand of many lawyers, a detailed list of prohibited functions and required actions. The assumption was that whatever was not prohibited or required was outside the law's parameters and thus left to the advisers' choices. Lawyers and their clients, therefore, searched for actions that were not prohibited, regardless of ethical considerations and of the purpose of applicable laws.

The new rule suggests the demise of this former approach of the Commission, and of lawyers' practice of searching for ingenious ways around the law. The Rule requires compliance officers and advisers to create policies and procedures to prevent violations of the law. No list is provided. Also, the Rule: (1) offers principles and standards rather than details, and (2) tells the compliance officers and advisers how to create the policies and procedures. The Rule aims at actions or inactions that produce the evils that the laws were designed to prevent, without specifying how these evils were achieved. Under this scheme, creative circumvention of prohibitions or requirements may not be sheltered from law if they result in the evils that the main rules were designed to avoid. The effect of such jurisprudence is to make it far more risky for advisers and professionals to look for loopholes and assume legality.

The main test will be the extent to which the Rule is enforced. The Commission might enforce the Rule strictly because: (1) it let private sector vendors offer advisers, especially small advisers, "policy and procedure packages," and (2) it seems to reduce the Commission's cost in examining advisers. The compliance system would present the examiners with red flags, and some requirements do not necessitate proof of intent. In sum, the Rule has shifted to advisers part of the burden of enforcing applicable laws, and it has told the advisers how to handle that burden.

The Rule imposes costs on advisers, especially smaller advisers whose competitive position is rendered weaker. If the costs are very high, and advisers are not competitive in other ways, there likely will be a consolidation of the advisory profession. However, without a Rule, a "creative" adviser may find ways of earning money by "shading" transactions. Rule 206(4)-7 may help establish a culture of honesty within advisers' organizations. It may speed the return to self-limitation and policing within the advisers'community.

Securities laws and SEC regulations do NOT allow market regulators to violate the Constitution.

Besides disclosure requirements, the 1934 Act has some anti-fraud requirements

**Statute 10-b (1934 Act) & SEC Rule 10-b-5 – both are anti-fraud securities laws

Their coverage extends to about every aspect of the transaction
-Just need a connection to interstate commerce (do not need to be on a stock exchange).
-Law NOT limited to those companies that must file 10-Qs and 10-Ks.

They have essentially the same scienter requirement as for common-law claims that a defendant
fraudulently induced a contract
– Mere negligence is NOT enough (though probably sufficient under Section 11).

Potential defendants – issuers, underwriters, corporate
officers, and experts (e.g. accountants, auditory lawyers) could be indicted or sued or both- criminal and
civil coverage - e.g., Ivan Boesky, Dennis Levine, Michael Milken

**Who has standing to sue?**
Actual buyers or sellers of securities may sue for both rescission and damages There is No standing from mere inaction – i.e., cannot just claim a loss because one held onto, or did not purchase, securities; the alleged fraud must have led the plaintiff to act, not sit.

**Statute of Limitations**
In the Sarbanes-Oxley Act, Congress increased the statute of limitations from one year from when a claim could have been reasonably discovered or three years after the purchase, in most cases, to two years from discovery and five years after the event. But Congress did that, not by amending the 1933 or 1934 Act, but by amending the general

fraud statute of limitation in Title 28. Thus, the increase of time is, on its face, limited to fraud cases (not, for example, due diligence claims).

What do investors need to prove in securities fraud suits in the wake of a landmark Supreme Court decision (*Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164 (1994)) and the PSLRA (described below)? It appears that "reckless misconduct" is insufficient to demonstrate that the defendant had the required state of mind to commit fraud. The Central Bank of Denver case seemed to strip corporate consultants (e.g. accountants, or attorneys) of legal liability for merely assisting their clients' fraud; but the PSLRA evidently restores to the SEC the right to file disciplinary cases (e.g., seek to bar professionals from practicing in the securities field) if those professionals did "aid and abet" others who committed fraud. (The Supreme Court in Central Bank ruled that an accountant or other professionals cannot be held liable under Statute 10-b or Rule 10-b-5 for merely assisting a client to commit a securities fraud ("aiding and abetting"); the PSLRA, though, gives the SEC the authority to bring administrative action against those who aid and abet a securities fraud.)

Auditing firms are also extremely unlikely to face RICO liability for conducting a faulty audit. Unless the auditor actually participated in controlling a client's business, the auditor has no RICO liability for the client's securities fraud. Reves v. Ernst & Young (U.S. Supreme Court, 494 U.S. 56, 1993). The PSLRA provides that conduct actionable as fraud under the securities laws cannot be the basis of a RICO claim except when the defendant has been criminally convicted in the fraud.

In recent years, almost all securities suits have involved alleged accounting abuses or the allegedly wrongful allocation of shares in IPOs (initial public offerings). The IPO suits principally are directed against technology, telecom, and biotech companies, as well as the securities firms that brought them to market. Many cases involved allegations of "laddering" – a common practice during the stock bubble that ended in 2000-2001. In such cases, certain investors promised to buy additional shares of new issues at progressively higher prices, kicking back a percentage of the profits they made on the hottest prices by rewarding the brokerage firms with additional business.

The questionable accounting practices cases particularly concerned improper revenue recognition or artificially inflated revenue. For example, companies particularly software companies, recognized revenues even though the product never left the warehouse or when it was defective and sure to be returned. Common securities suit defendants have been high-tech, pharmaceutical, oil, and utilitycompanies.

**The Private Securities Litigation Reform Act (PSLRA)**
-Proponents contended that whenever securities values fell, a company could easily be sued and compelled to answer (or pay off) what was essentially a "nuisance" suit (baseless, but nonetheless troublesome)

Enacted in December 1995 over President Clinton's veto, the PSLRA:

1. Requires plaintiffs to state with greater specificity the facts indicating defendant's scienter (plaintiffs intheir complaint must present details "giving rise to a strong inference" of fraud.)
2. Provides that any discovery is frozen pending a judicial ruling on a defendant's motion to dismiss (previously, plaintiffs' attorneys could start gathering documents and interviewing witnesses when the complaint was filed).
3. States that attorneys' fees and other costs must almost always be imposed for filing a frivolous securities law claim.

The PSLRA substitutes proportionate liability for the old law under which everyone involved in the financial scheme would be fully liable for all the damages involved. So, in most circumstances under the new law, the amount for which an accounting or law firm could be held liable would be only a fraction of the 100% for which it might previously have been sued. This could be crucial for plaintiffs when a defendant company, such as Enron or WorldCom, is in bankruptcy court.

Finally, it limits the use of the Racketeer Influenced and Corrupt Organizations Act, (RICO) in civil suits involving securities. Rico is very unpopular with corporate defense attorneys, because, among other provisions, it permits an award to plaintiffs of triple damages.

(a) and (b), above, together, may present a Catch-22: One cannot get discovery unless one has strong evidence of fraud, and usually one cannot get strong evidence of fraud without discovery!

Balancing Issues
<u>The PSLRA was meant to reduce the number of frivolous securities claims without barring legitimate claims.</u>

Despite the PSLRA, the number of securities cases filed in federal courts seeking class-action status rose 50.3% from 1995, to a then-record 266 in 1998, to nearly 350 in 2001 - while the average cost to settle jumped nearly 40%, from $7.8 million in 1997 to almost $11 million in 1998. (Data were collected by National Economic Research Associates, a unit of insurance broker Marsh & McLennan Companies.) Ironically, by raising the hurdle for lawsuits, the PSLRA may have led plaintiffs' attorneys to spend more on building their cases, and thus they often are less willing to settle cheaply. The PSLRA shifted the classaction rule emphasis, permitting practically any investor to bring action (typically instigated by lawyers racing to the courthouse to be first to file a case and control the legal fees) to cases in which the investors with the largest losses (often, large pension funds) frequently seek bids from attorneys and otherwise control the case. So the PSLRA has led to large institutional investors obtaining more control over these securities-based lawsuits, and plaintiffs' attorneys having less control.

The size of securities class actions keeps increasing. The average settlement in 2002 was 24 million dollars, up from 14 million in prior years. The Cendant case settled for 3.5 billion dollars; Bank of America settled a case for 490 million dollars. Both are enormous amounts, far beyond any business' insurance, and that has greatly affected how the settlements are structured.

About 28 percent of these securities cases are dismissed, usually on a motion to dismiss and sometimes on a summary judgment. Of those cases that survive the motion, virtually all settle. So the plaintiff's goal is pretty straightforward: to draft a complaint that will survive a motion to dismiss, because, if that occurs, the plaintiff is likely to get a payday. More and more plaintiffs have hired private detectives and spoken to former employees; the result is a very long complaint, intended to state enough of a factual predicate so that a judge will agree the parties should proceed into the discovery stage.

And judges fall into two categories: those who look hard at the allegations and say, at least in a 10-b-5 case, where one must allege fraud, "You must plead with particularity - to have evidence of scienter." And other, more lenient judges effectively decide, "It is just a pleading, so let's go forward." Moreover, when it comes to Section 11 cases, a lot of due diligence issues come up, and the issue is not fraud. Therefore, many judges have clarified that the PSLRA's heightened pleading requirement (the need to plead with particularity) does not apply to a Section 11 claim: the plaintiff simply has to lay out an alleged misstatement, and then the parties proceed to discovery.

Under the PSLRA, a corporation can avoid liability for profit predictions by including a discussion of business factors that might undermine the forecast. Other companies in similar situations have included the following information and warnings:

> "Customer demand and other trends may adversely affect sales."
> "Certain statements contained herein which are not historical facts are forward-looking statements that involve risks and uncertainties."
> "Interest rates, labor disputed, raw-material availability, and weather conditions could make the predictions inaccurate."

Probably the most important PSLRA protection for companies and management is the zone of immunity it creates for corporate forecasts. This is called a "safe harbor" provision by its proponents and a "pirate's cove" by its detractors. The provision lets companies preview earnings and products with less fear of legal reprisal if they are wrong.

**Insider Trading**

What is Insider Trading?

Insider information is material, nonpublic information that can affect a securities price. Insider trading involves trades based on such insider information, when the culpable party knows that the information has been obtained fraudulently.

Punishments for Insider Trading: Persons engaged in insider trading are subject to lawsuits and to criminal charges.

Some History

The antifraud provisions (e.g., 10-b) of the Securities Exchange Act (1934) is the basis for present insidertrading cases. But until the early 1960s, the SEC generally ignored insider trading, which was not directly mentioned in the 1934 Act. Lawmakers who enacted the 1934 Act evidently never even contemplated restricting insiders from profiting on or selectively passing along a hot tip. Only in cases where an insider bought or sold securities in a private, face-to-face transaction (obviously, not what takes place in secondary market transactions – such as via stock exchanges) might an insider have been held liable for not disclosing to the other party the insider's material information. As stated by the Supreme Judicial Court of Massachusetts in the case of Goodwin v. Agassiz (1933), a decision finding no legal

fault with a corporate executive's insider trading, "Law in its sanctions is not coextensive with morality. It cannot undertake to put all parties to every contract on an equality as to knowledge, experience, skill, and shrewdness."

That approach, found in Goodwin v. Agassiz, changed in the early 1960s under an activist SEC Chairman that Pres. John F. Kennedy had appointed, William Cary. Cary decided that the SEC should pursue insider trading. Cary's reasoning was that "few actions were more likely to reduce confidence" in the markets than the failure to ensure that all investors have "*relatively equal access* to material information."

Since the 1960s the U.S. Supreme Court has moved away from the equal-access principle to a finding that the key issue in insider-trading is whether the insider breached some fiduciary duty by trading on nonpublic information.

Statistics
In 1987, the SEC investigated 169 cases of insider trading.
In 1997, it investigated far more insider trading cases: 365.
The numbers remain high.

Must the government show that a corporate insider actually used inside information as a basis for trading securities?

In SEC v. Richard J. Smith (decided September 1998), the Ninth U.S. Circuit Court of Appeals (based in San Francisco) held that the answer is "Yes." Under this holding, defendants may use as a defense to insider trading allegations the argument that they were planning the trade, for example, as part of a preexisting trading program, regardless of whether they had inside information when they traded.

Earlier in 1998, the Fifth Circuit U.S. Court of Appeals (based in New Orleans) held that the government must show that the insider used the inside information, but added that possession of the information could provide a "strong inference" of use.

In 1993, the Second Circuit U.S. Court of Appeals (based in New York City) favored the SEC's long-held view that the mere knowing possession of inside information is enough to prove that trading was illegal insider trading.

Because of these conflicting holdings by the federal courts of appeal, the U.S. Supreme Court may ultimately have to decide this issue.

Who are insiders?
Reporting insider transactions – SEC rules require that corporate officers and directors who sell company stock in the open market must file a disclosure form with the SEC by the 10th day of the month after the sale. But SEC rules allow insiders to file reports on sales back to the company just once a year, with the deadline for filing not coming until 45 days after the company's fiscal year ends.

In 2001, there were over 450 such insider sales back to the company, often reported after a much longer time than a month (e.g., many months, up to a year) after the sale. This time differential in the rules may induce such sales back to the company and enable insiders to legally delay the public disclosure of their inside transactions by as much as a year (thereby effectively misleading other investors). In the wake of Enron, and long-delayed disclosures of multi-million dollar sales by insiders at many other companies (e.g., Tyco Int'l Ltd., Lucent Technologies, Ford Motor Co., and Campbell Soup Co.) Congress or the SEC may close this "loophole."

The SEC has moved to close the loophole, as it proposed in June 2002 the speedier filing of annual and insider-trading reports.

Who are tippees?
Just like insiders, tippees can be liable under 10-b and cannot act on inside information, nor give it to others.

While the insider trading definition seems simple, the law tends to get quite murky when specific circumstances are considered. Other systems – e.g., in Europe – historically have defined insider trading with more certainty, although almost none (including those with well-defined strictures) have actually enforced the insider trading laws as stringently as has the United States. The trend, though, in the European Union, Japan, China, and elsewhere, is to enforce insider trading laws more and thus to encourage more investment.

Using international data and alternative regression specifications, legal and financial scholars have found that stricter insider trading laws and enforcement are generally associated with greater ownership dispersion, greater stock price accuracy and greater stock market liquidity. These empirical findings support the theoretical arguments favoring stronger insider trading legislation and enforcement.

**B. Insider Trading Video**
**VIGNETTES ON SECURITIES LAW - "INSIDER TRADING: LAW AND EXAMPLES"**

Peter, the President of a large corporation, tells his friend, Otto Outsider, that another company is about to make a lucrative offer for the corporation's stock. Otto buys as much stock as he can lay his grubby hands on, including stock owned by Ingrid Ignorant.

Later, when the other company's offer for the stock is announced, the price per share skyrockets. Otto makes a bundle. Peter can certainly expect return favors from Otto. And Ingrid feels cheated.

Bamboozled. MAD.

Are the corporation, its officers, or Board of Directors liable for not announcing a potential merger? In other words, should they have made a special announcement and filed an 8-K when they first learned of the other company's possible interest in the corporation?

The SEC permits corporations to not have to disclose merger negotiations if: (1) the corporation did not make any prior disclosures about those negotiations; (2) no other SEC rules require disclosure; and (3) Management determines that disclosure would jeopardize completion of the merger transaction. So there usually is no liability for not having an announcement about a merger that is still uncertain.[2]

As for Peter and Otto - both have violated the insider trading laws. This is the classic simple case of an insider, Peter, who tips off another person, Otto, the tippee. Both have committed Section 10-b and Rule 10-b-5 securities fraud due to their insider trading.[3] They can be held both civilly and criminally liable.

[The rest of the examples shown are from actual cases.]

Some trades based on inside information are perfectly legal. One can be an innocent profiteer! Football coach Barry Switzer is at a track meet when he inadvertently overhears a Mr. Platt mention to Mrs. Platt an impending corporate sale. Switzer trades on and profits from the information.

Once they see how the stock price has gone way up, those who sold their shares are - of course - quite sad. But their feelings of loss do not translate into liability or guilt for Switzer. Since Mr. Platt does not mean to tip off Switzer, Mr. Platt is not an illegal tipper. And thus Switzer cannot be an illegal tippee. A tippee is only liable if he knows or should know that he has received secret information that was wrongfully passed onto him.[4]

(And there is nothing wrong with conveying a rumor that a company's stock is about to slide - e.g., a broker's telling a client to sell because the broker has a feeling the price is going to drop. But saying that is because a government agency – the Food and Drug Administration - is about to reject, for example, a major drug such as ImClone's cancer-fighting drug, Erbitux, is unlawful.)[5]

---

[2] Am. Jur. Admin. Law § 94.

[3] It is also a violation under the Insider Trading Securities Fraud Enforcement Act (1988).

[4] *SEC v. Switzer*, 590 F. Supp. 756 (D. Okla. 1984).
In an insider trading case, is there a legal obligation for a tippee to report a tipper? In other words, can a tippee be charged with a crime for failing to report a tipper to the authorities? NO. One who is privy to inside information can refrain from acting on it and avoid civil, or at least criminal, liability. One can analogize to the theft of tangible property. If a thief offers to give or sell stolen property to you, do you have a responsibility to report the thief to the authorities? Moral responsibility -- yes. Criminal responsibility – probably not, although knowingly receiving stolen goods can be a crime. Also, there could be a criminal charge related to perjury if authorities asked questions.

[5] For the Martha Stewart case, several reported decisions concern different phases of her trial and appeals. The major citation is *United States v. Stewart*, 305 F. Supp. 2d 368 (S.D. N.Y. 2004), but please note that Martha Stewart actually

So, if I am on a golf course and some guy I do not know says, “let me give you a really good stock; I hear this company is about to be taken over” – That is Not illegal insider information. But if he adds that he is the CEO of that company, then there could be liability.

Here is an example closer to the middle line: Suppose that a broker, without giving a reason for a CEO’s actions, tells his/her client that the CEO is dumping a lot of stock. That comes close to the illegal insider trading line, but may not cross it. Who knows why the CEO is selling? Maybe he/she just wants some cash to help purchase that little summer cottage, with 12 bedrooms, costing, say, $30 million!

Plaintiffs and prosecutors, of course, do not always know the exact contents of conversations between a tipper and a potential tippee. But even if they lack documentary evidence, such as an e-mail or a taped telephone call, they can make cases by asking a judge/jury to “infer” that inside information was passed along based on factors such as the timing and circumstances of the stock sale and phone records showing there was contact.)

If a noted Florida Economics Professor likes to go through public dumpsters in search of interesting paraphernalia, and he spots a document marked "confidential" about a proposed corporate transaction set to take place a week later, he could trade on that information without violating the securities laws. He was not intentionally tipped off. It also would help the Prof's defense that he really is taking a risk because he has no way of being certain that the corporation has really decided to, and will in fact, carry out, the transaction discussed in the document. Maybe the document was trashed because the idea was trashed![6]

Other than an intentional communication of inside information, the only other way to hold liable the outsider, that is, the non-insider, is the misappropriation theory.[7] That theory is based on a defendant's alleged breach of duties by improperly "appropriating" (using) confidential information. The theory has allowed the SEC, working with the Justice Department, to obtain insider trading convictions and/or civil judgments against persons who use confidential information but are not company "insiders." An SEC official estimates that since 1992 as much as 45% of its insider-trading cases have involved misappropriation.

When financial newspapers or magazines speak favorably or disparagingly about certain companies, that obviously can affect the trading volume and price for stocks in those companies. Thus these financial periodicals, such as Business Week, require that their contents be kept confidential until released to the public.

An employee of Business Week's printer meets two tippees and sells them advance copies in violation of the printer's own confidentiality rules. One of the tippees, in turn, passes the advance copies on to another person. Substantial sums are made while trading occurs based on the advanced copies. In this actual case,[8] the U.S. Circuit Court approved and affirmed the insider trading convictions based on misappropriation of private property.

It did this because: (1) the tipper breached his duty of confidentiality; and (2) the tippee knew that the tipper had breached this duty of confidentiality. The government need not show that the tipper or tippee personally benefited or that the tipper knew what the tippee would do with the inside information. The Court said it was protecting property rights in information and clearly the tipper must know that the tippee's interest in the information is "Not for Nothing." So both tippers and tippees are guilty. If, however, the chain of tippees gets long and attenuated, the courts likely will find no illegal insider trading at the end of that chain. In a 1991 case, *United States v. Chestman*, 947 F.2d 551 (2nd Cir. 1991), the defendant heard about a possible buy out of a grocery chain. The information came to the defendant from a man whose wife was a niece of the president of the grocery chain. The court overturned a conviction because there was No proof that the defendant knew the tip breached a duty to keep information secret.[9]

---

was convicted of perjury (not insider trading). District Court Judge Cedarbaum held that the evidence was insufficient to support a securities fraud conviction.

[6] In essence, the hypothetical professor tipped himself by acquiring the information without the other party’s knowledge or consent. Perhaps *whose* intent is important; we can distinguish accidental procurement of information versus intentional procurement on the tippee side, but without the tipper knowing.

[7] The misappropriator gets the information with the other party’s consent (unlike the hypothetical economics professor in the above example), but under a limited pretext and with an understanding of confidentiality (like the case of the Business Week printer).

[8] The case was *United States v. Libera*, 989 F.2d 596 (2d Cir. 1993).

[9] *Chestman* is still good law. Indeed, recent regulations have strengthened and expanded *Chestman* duties. See, e.g., *United States v. Kim*, 173 F. Supp. 2d 1035 (N.D. Calif. 2001).

After passing through several channels, when does what might have been considered confidential business information become merely market gossip - with no expectation of confidentiality? In insider trading cases, the factual circumstances, and the underlying legal questions, revolve around duties - broken duties to keep information confidential. [10]

Let us next consider *SEC v. Dirks*, 463 U.S. 646 (1983) (a U.S. Supreme Court Decision). Raymond Dirks, an investment analyst, talks with several former and present employees of Equity Funding of America. Dirks decides that Equity Funding's assets have been vastly exaggerated due to fraudulent corporate practices. Over a two-week period, as Dirks investigates and spreads the word about Equity Funding, its stock price falls over 40%. Then the New York Stock Exchange halts trading and soon thereafter Equity Funding dissolves. Equity Funding had, indeed, been rife with fraud.

The SEC found that Dirks was a tippee who had violated insider trading laws by passing on inside information to others who then sold securities based on that information. But the Supreme Court, in effect, held that the pure motives of the parties meant that there was no illegal insider trading. That was because Equity Funding employees' disclosures to Dirks were not motivated by personal gain, nor was Dirks' communicating this information to others meant to enrich him. Because he sought to expose fraud, Dirks had No duty to refrain from using the information he had obtained.[11] (On the other hand, the purity of Dirks' motives contrasts with the defendants' behavior in *People v. Napolitano*, 724 N.Y.S.2d 702 (App.Ct. 2001). In *Napolitano*, the court found that the intent to expose fraud in *Dirks* was much different fromthe intent to procure personal gain, seen in *Napolitano*.)

We have, against insider trading, strong federal laws, with strong enforcement given the limited resources available. But definitions and standards in complex cases are still sometimes vague. The 1984 Insider Trading Sanctions Act and the 1988 Insider Trading and Fraud Enforcement Act both increased the jail time, fines, and civil penalties for insider trading violations. And the 1988 Act gave the SEC greater rulemaking power to mandate specific procedures intended to prevent insider trading. The SEC also was given authority to award "bounty" payments to persons providing information leading to insider trading convictions. Whatever penalties are assessed in an insider trading case, the whistleblower can get a percentage - up to 10% of the penalty amount - as a reward.

Another statute on corporate insiders besides 10-b is Section 16 of the 1934 Act.[12] Section 16-a requires corporations regulated under the '34 Act, as well as those corporations' officers and directors, and also any shareholders holding more than 10% of the shares, to file reports with the SEC concerning their ownership and trading of the corporate shares. 16-b provides for automatic recapture by the corporation of insiders' profits when those insider officers, directors, or 10%-plus shareholders make a short-term profit by selling or buying the corporate shares within a 6-month time frame.[13]

---

[10] For criticism of the misappropriation theory and the 1997 *O'Hagan* decision, see Holman Jenkins, Jr., "Knowing Naughty Information from Nice," WALL ST. J., July 22, 1997, at A15. On the misappropriation theory, two important sources are: (1) the seminal case, *United States v. Hagan* (a good website explaining the impact of the case is http://www.torys.com); and (2) a nice discussion of insider trading and misappropriation at Westlaw citation SKO66 ALIABA 199 ("Materiality, Informal Disclosure, Soft Information, and Forward-Looking Statements Under Securities Laws").

[11] In a July 1998 decision by the Second U.S. Circuit Court of Appeals, the court held that passing on information to someone with whom the tipper has a close relationship suffices for inferences that the tipper benefited. In SEC v. Thomas Ward, the court clearly affirms that tippers/insiders do not have to obtain a concrete, tangible item in return for the tip. See also SEC v. Danaher, et al., Civil Action No. 01 CV 8431 (TPG) (S.D. N.Y.) / SEC Litigation Release 17125 (in which Ward is a named party), and its companion case, SEC v. Harry Parker Daily, et al., Civil Action No. 01 8432 (TPG) (S.D. N.Y.) / SEC Litigation Release 17124 (in which Ward is not a named party).

[12] 15 U.S.C § 78p (2005) (the citation for Section 16 in the U.S. Code of federal statutes).

[13] In 1999, the SEC eased the section 16 rules restricting insider trading. The new rules exempt corporate insiders from the trading and reporting restrictions on purchases and sales of their companies' securities when:

- The transactions involve an employee benefit plan sponsored by the company.
- The plans are thrift, stock purchase or excess benefits plans that are typically considered "tax conditioned" by the tax code.
- The transactions take place through a dividend or interest-reinvestment plan that offers similar investing terms for all holders of a type of company security.
- Assets are moved into or out of a company stock fund, as long as buying and selling transactions are at least six months apart.
- The company's board, a panel of outside directors, or shareholders sign-off in advance on transactions that do not fall under the previously mentioned plans.

The most important 16-b case involved the Emerson Electric Company, which owned 13.2% of Dodge Manufacturing Company's stock. (The case was a U.S. Supreme Court decision, Reliance Electric Co. v. Emerson Electric Co., 404 U.S. 418 (1972).) Just two months after buying the stock, Emerson sold enough shares to bring its holdings down to 9.96%. That was structured in such a way that Emerson did not yet register a profit on its stock transactions. Then, two weeks later, Emerson sold the rest of the stock, at a tremendous profit.

Did Emerson have to disgorge the profits on its sale? No. Emerson was not an "insider" under Section 16. It was not a director or officer. It was not a holder of more than 10% of Dodge's stock at the time of the sale in question. Section 16 is an arbitrary, rather technical statute that draws a stark line between those groups and transactions which are covered and those which are not. So Emerson was free to act in ways which would place it outside Section 16's coverage.

Emerson could have avoided Section 16 by waiting more than six months to sell the shares. Instead, it did not wait, but simply sold enough shares to go below 10%, and then sold the rest. That way Emerson kept Dodge from being able to recapture the short-swing profits Emerson made off of Dodge stock. In effect, Emerson acted like a taxpayer who takes advantage of all the deductions and credits he can use to lower his income tax. As long as one does not violate the literal wording of Section 16, one can structure the amounts and timing of stock purchases and sales so as to keep profits rather than have to give those profits back to the corporation.