Insider Trading: The Basics Every Compliance Professional Ought to Know

by Lorna A. Schnase

Introduction

Not long ago, Galleon hedge fund manager Raj Rajaratnam was convicted in the largest insider trading case in U.S. history. Since then, the government has brought an unprecedented number of insider trading cases – both criminal and civil – continuing to focus the spotlight on this area of the law.

This article answers basic questions about insider trading that every compliance professional ought to know in order to function effectively in the current enforcement environment, from the definition of insider trading to the principal theories of liability, the potential consequences for violation and common methods aimed at prevention.

In the "Forms, Templates, Tools" section of this issue is a sample Insider Trading Policy illustrating how certain points discussed in this article might be implemented in practice as part of an overall compliance program. The sample policy is designed for an investment advisory firm but could serve as a useful resource for any firm crafting its own insider trading procedures.

The Goals Behind Insider Trading Laws

Why does U.S. law prohibit insider trading?

Insider trading laws are aimed at leveling the "playing field" between traders who have access to material, nonpublic information and those who do not, to avoid the unfair use of information in trading. Ultimately, this is an effort to ensure the integrity and transparency of the U.S. securities markets and maintain public trust and confidence that the markets are not unfairly biased or "rigged." This is considered a cornerstone to keeping the U.S. markets among the most highly respected, active and efficient in the world.

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What other approaches might be taken to insider trading?

Historically, not all countries have approached insider trading like the U.S. Indeed, some countries – as well as commentators – take the view that insider trading should not be illegal but rather is one mechanism to keep markets efficient and promote price discovery.[1] While the academic debate about insider trading may never be over, by now, regulators in most of the world's major securities markets prohibit insider trading under the broad umbrella of "fraud."[2]

The Basic Legal Framework

What is the definition of insider trading?

None of the major federal securities laws define insider trading *per se*, or indeed include any specific prohibition against insider trading using that term. Instead, insider trading prohibitions emanate largely from case law developed by interpreting various anti-fraud provisions, primarily under the Securities Exchange Act of 1934 (the "Exchange Act"). From that case law, the following definition of insider trading might be extracted:

> "Insider trading" is the purchase or sale of securities, with scienter (a state of mind implying an intent to deceive), on the basis of[3] material, nonpublic information, in breach of a duty arising out of a relationship of trust or confidence.[4]

That basic definition prohibits insider trading in the classic scenario in which "insiders" – such as officers and directors of public companies – trade in the stock of their own companies when they know something significant about the company that the rest of the market does not. However, it also prohibits other types of insider trading, well beyond the classic scenario, discussed in more detail below.

What provisions in the securities laws are used to bring insider trading cases?

As noted, there is no specific provision in the federal securities laws that outlaws insider trading *per se*. Insider trading cases are typically brought under more general anti-fraud provisions. The key provisions that ground insider trading cases are –

Rule 10b-5 promulgated under Section 10(b) of the Exchange Act. Rule 10b-5 is a broad rule that generally outlaws fraud and deceit in connection with the purchase or sale of a security. This is the key provision that grounds most insider trading cases. Some insider trading cases may also allege violations of Section 17(a) of the Securities Act of 1933, although by its terms Section 17(a) applies only to fraud in connection with the *offer* or *sale* of a security and not to fraud in connection with a *purchase*.

Rule 14e-3 promulgated under Section 14(e) of the Exchange Act. Rule 14e-3 is another anti-fraud provision that specifically applies to tender offers, transactions in which a bidder publicly offers to buy some or all the outstanding securities of an issuer. Rule 14e-3 is as close as it gets under the federal securities laws to a specific prohibition against insider trading. It contains more granularity than Rule 10b-5 in defining prohibited conduct and specifically prohibits trading during a tender offer on the basis of "material," "nonpublic" information (MNPI or 'inside' information) derived from various sources. It also prohibits certain persons – generally the tender offeror, the issuer, their officers, directors, employees and advisors, and anyone with MNPI acquired from any of those persons – from communicating that MNPI to anyone else if it is reasonably foreseeable that it will result in a violation of the rule. Notably, however, the rule does not define what constitutes MNPI. Moreover, the prohibitions are not confined to "insiders" or even to those persons who might logically be considered insiders.

Among the other provisions important to the law of insider trading are –

Short-Swing Trading under Section 16(b) of the Exchange Act. Subject to certain exemptions, Section 16(b) creates liability for any profit realized by an officer, director or 10%+ beneficial owner of a publicly traded company resulting from any short-swing 'round trip' transaction – a purchase and sale, or a sale and purchase – in the issuer's equity securities within a period of 6 months. Unlike liability under Rule 10b-5, which requires a showing that a person acted with "scienter" (a state of mind implying an intent to deceive), Section 16(b) is a prophylactic measure that does not require showing scienter. Rather, it aims to prevent the unfair use of information that *may* have been obtained by reason of the person's relationship to the issuer, regardless of intent. Profit derived from a Section 16(b) violation is owed to the issuer.

Whistleblower Provisions. Whistleblower provisions previously in effect have been largely superseded by the more comprehensive whistleblower program implemented under the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. Under that program, whistleblowers may be entitled to a bounty ranging from 10% to 30% of the money collected if they voluntarily provide the SEC with original information regarding any securities law violation, including insider trading, which results in sanctions of over $1 million.

Reg. FD (Fair Disclosure) under the Exchange Act. Regulation FD aims to avoid selective disclosure by requiring an issuer to make public disclosure of MNPI whenever it discloses that information selectively to certain persons, such as securities market professionals and holders of the issuer's securities who may well trade on the basis of the information. If the selective disclosure was intentional, the issuer must make public disclosure simultaneously. If the selective disclosure was non-intentional, the issuer must make public disclosure promptly. The required public disclosure may be made by filing a Form 8-K with the SEC, or by another method or combination of methods that is reasonably designed to effect broad, non-exclusionary public distribution of the information.

Other provisions important to the law of insider trading are discussed elsewhere in this article, such as rules that supplement Rule 10b-5, provisions requiring securities firms to self-police for insider trading and statutes establishing the sanctions and penalties available for violations.

What is the role of case law?

As already mentioned, case law has been instrumental in the development of insider trading law. Given that the key anti-fraud provisions grounding these cases are so general, it has been up to the courts to interpret those provisions in light of their purpose and apply them in real cases. Through that interpretive process over some 70 years now, the law of insider trading has taken form.[5]

What is the current state of the law?

The law of insider trading is still evolving. This is *not* because Rule 10b-5 or the other key provisions have changed much. Indeed, Rule 10b-5 itself has not been amended since it was adopted in 1951. Rather, this is because insider trading law is largely case made law and, recently, the government has been particularly active in bringing insider trading cases that may well continue shaping the law in this area.

Common Myths About Insider Trading

Myth: There is a law that says, in essence, thou shalt not commit insider trading.

As noted above, the truth is that there is *no law* – at least among the federal securities laws – that expressly prohibits insider trading *per se*. Rather, courts have interpreted more general anti-fraud provisions to outlaw insider trading and define the key concepts of insider trading law.

Myth: Insider trading laws are aimed at corporate "insiders" trading in their own company's securities.

While it is certainly true that traditional corporate "insiders" – such as officers, directors and principal owners – are subject to insider trading prohibitions, there are theories of insider trading liability that catch far more than traditional corporate insiders and, indeed, can catch corporate "*outsiders*," meaning traders who have no relationship whatsoever to the company whose securities are being traded. This is explained in more detail below.

Myth: Only the SEC can bring insider trading cases.

Of course the SEC can bring insider trading cases under the federal securities laws, but the SEC's reach is limited given that it only has civil jurisdiction. Criminal insider trading cases are brought instead by the U.S. Department of Justice. In addition, state regulators enforce their own securities laws outlawing insider trading.[6] Private rights of action also exist to enforce certain insider trading prohibitions.[7] As a result, in addition to the SEC, the DOJ, state regulators and private plaintiffs may all bring insider trading cases.

Identifying "Inside Information"

As noted above, insider trading may be defined as trading on the basis of "inside information" or – to use the legal phrase – "material, nonpublic information" (MNPI). Unfortunately, just as they do not define insider trading, the major federal securities statutes do not define MNPI either. Once again case law and other guidance must be used to determine what constitutes MNPI.

When is information considered "material"?

According to case law, information is considered "material" if there is "a substantial likelihood" that a reasonable investor would consider it important in making an investment decision by having significantly altered the "total mix" of information made available.[8] Courts routinely reject bright-line and rigid mathematical tests for materiality.[9] Instead, materiality is determined under a 'facts and circumstances' test. Whether circumstances yet to happen would be considered material requires balancing the probability the event will occur as well as the anticipated magnitude of the event.[10]

Both qualitative and quantitative factors can be relevant to materiality. Blind use of quantitative rules can be dangerous, like assuming any impact of less than 5% will always be immaterial.[11] Instead, when assessing the materiality of quantitatively small financial information, guidance recommends considering whether the information:

- is capable of precise measurement or is based on an estimate, and the degree of imprecision inherent in the estimate;
- impacts earnings or other trends;
- hides a failure to meet analysts' consensus expectations;
- changes results from negative to positive, or vice versa;
- impacts a significant business segment;
- affects compliance with regulatory matters, loan covenants or other contractual requirements;
- affects management's compensation; or
- involves the concealment of an unlawful transaction.[12]

A non-exhaustive list of information and events that are likely to be considered material include:

- earnings information;
- mergers, acquisitions, joint ventures or tender offers;
- acquisitions or dispositions of company assets;
- new products or discoveries;
- developments regarding customers or suppliers (such as the acquisition or loss of a contract);
- changes in control or management;
- changes in a company's auditors or receipt of notice that the company may no longer rely on an audit report;
- events regarding a company's securities, such as:
- defaults on senior securities;
- a call of securities for redemption;
- repurchase plans;
- stock splits or changes in dividends;
- changes to the rights of shareholders;
- the public or private sale of securities; and
- bankruptcies and receiverships.[13]

When is information considered "nonpublic"?

Information is considered nonpublic when it has not been disseminated in a manner making it available to investors generally.[14] Information will be considered public once it has been broadly disseminated, such as when it is reported through the Dow Jones Newswire or in similar widely disseminated publications, and the public has had a reasonable time to absorb the information.

Sources vary widely on how much time must pass before disseminated information becomes public, ranging from 15 minutes after the news runs, to 6 hours, to the next morning, to 24 or 48 hours, to 9 days after release.[15] A commonly used standard treats information as "public" if it has been disseminated broadly for at least 48 hours,[16] leaving unanswered the question of whether a shorter period would suffice. Of course, 48 hours seems like an eternity in today's world of instant messaging, social media and rapid-fire electronic communications, and this may be a circumstance where the law has simply not yet caught up with reality.[17] However, even if future cases challenge the old standards, courts will likely still analyze the issue as always, based on all the facts and circumstances, focusing on how, where and how long the information has been disseminated.

The "Classic" Theory of Liability

What is the "classic" theory of insider trading liability?

The "classic" theory of liability is the one everyone seems to know. It targets individuals commonly thought of as a corporate "insiders," such as officers, directors or principal shareholders, who may well have access to information about the inner workings of a company, its prospects and key developments. When insiders trade in the securities of their own company – on the basis of MNPI – they fall within the ambit of the classic theory of insider trading liability.

What is an example of a classic insider trading case?

One well-known insider trading case based on the classic theory involved Sam Waksal, co-founder and CEO of biotech firm ImClone Systems. Between the time that Waksal became aware that the FDA was going to reject the company's new drug, but before that information became public, Waksal attempted to sell shares of ImClone stock from one of his brokerage accounts. He also caused his daughter to sell ImClone stock from her brokerage account and purchased ImClone put options in a Swiss brokerage account. In addition, he tipped his father about the impending FDA decision, who then also sold ImClone stock. Waksal family members reportedly avoided losses of several million dollars by making these sales before the stock price dropped when the FDA news became public. Waksal was convicted of several crimes and served time in prison. He also settled separate SEC civil charges for a substantial monetary sum.[18]

What other factors are important to the classic theory of liability?

Insider trading liability under key provisions – such as Rule 10b-5 – requires a showing that the individual acted with "scienter." As mentioned previously, "scienter" implies an intent to deceive or acting with a culpable state of mind. While this does not require showing the stricter "mens rea," the guilty state of mind often needed to establish criminal liability, it does require showing that the individual's conduct was more than merely negligent and, indeed, was at least reckless.[19]

Defenses to insider trading liability might also be available in any given case, especially when it is clear that the MNPI was not a factor in the decision to trade. Rule 10b5-1 under the Exchange Act spells out some of the circumstances affording an affirmative defense, such as when the person had, *before becoming aware of the inside information*:

- entered into a binding contract to purchase or sell the security,
- instructed another person to purchase or sell the security for the instructing person's account, or
- adopted a written plan for trading securities, in circumstances where the contract, instruction or plan meets certain restrictive criteria.

> ***Since [the conviction of Galleon hedge fund manager Raj Rajaratnam], the government has brought an unprecedented number of insider trading cases – both criminal and civil – continuing to focus the spotlight on this area of the law.***

The defenses afforded by Rule 10b5-1 give substance to the idea that not all trading by insiders involves culpability and should be illegal, such as when an insider may be in possession of MNPI but the MNPI is not used as the basis of the trading decision. Although insiders' use (or misuse) of this rule has come under scrutiny again recently,[20] there have been no SEC proposals to change the rule so far.

There are also categories of people beyond company insiders who could fall within the classic theory of liability. These include lawyers, auditors, underwriters, consultants or others to whom corporate information may be legitimately revealed in the regular course of business, but where it is expected that the information will be kept confidential. These are sometimes referred to as "temporary insiders," "constructive insiders," or "quasi-insiders," and they can be liable just like traditional insiders if they trade on the basis of MNPI learned while acting in that capacity.

The "Misappropriation" Theory of Liability

What is the "misappropriation" theory of insider trading liability?

The "misappropriation" theory is an alternate, court-created theory of insider trading liability based on an interpretation of Rule 10b-5. Under the misappropriation theory, a person who trades using MNPI misappropriated in breach of a duty of trust or confidence owed to the *source of the information* can be liable for insider trading.

The misappropriation theory is similar to the classic theory in that, under both theories, the trader is breaching a fiduciary duty or similar duty of trust or confidence. Under the classic theory, "insiders" breach a fiduciary duty owed to the company and its shareholders by using confidential company information to trade for their own personal gain and by using their informational edge to take advantage of uninformed shareholders who trade. Under the misappropriation theory, traders breach a duty of trust or confidence to the *source of the information* by using information expected to be kept confidential and trading on it instead. However, because the source of the information may not be the company whose securities are traded (or anyone connected to it), the misappropriation theory also goes way beyond the classic theory and can catch traders who are not "insiders" or even "temporary insiders." Indeed, it may catch traders who are corporate "outsiders," meaning they have no relationship whatsoever to the company whose securities are traded.

Take, for example, an airline executive who learns confidential information at work, that the airline will be awarding a major contract to a particular aircraft manufacturer. Before the contract is announced publicly, the executive buys stock in the aircraft manufacturer, anticipating (correctly) that the stock price will increase once news of the contract is widely known. Note that the executive is not an "insider" of the aircraft manufacturer, the company whose securities are traded. Indeed, the executive has no relationship to the manufacturer at all. However, the executive is an officer of – and therefore a fiduciary owing a duty of trust or confidence to – the airline, the *source of the information* about the major contract. The executive breaches that duty owed to the airline by "misappropriating" confidential company information about the contract and trading on it for personal gain. As a result, the executive could be held liable for insider trading under the misappropriation theory.

There is no specific provision in the federal securities laws that outlaws insider trading….

Like in this example, many misappropriation cases ground insider trading liability on a breach of the duty of trust or confidence emanating from the employer/employee relationship.[21] However, SEC rules tell us that a duty of trust or confidence can also arise in other circumstances for purposes of the misappropriation theory, such as when:

- persons agree to keep information confidential;
- persons have a history, pattern or practice of keeping information confidential; or
- persons are spouses, parents, children or siblings.[22]

This list is not exclusive, so it is possible that other circumstances could also give rise to a duty of trust or confidence capable of grounding insider trading liability if MNPI misappropriated from the source is used for trading purposes.

What is an example of a misappropriation insider trading case?

A key case defining the misappropriation theory involved James O'Hagan, a lawyer with the law firm of Dorsey & Whitney. Corporate giant Grand Met retained Dorsey & Whitney to represent it regarding a potential tender offer for food maker Pillsbury. After this representation began but before the transaction became known publicly, O'Hagan – a Dorsey & Whitney partner who, incidentally, did no work on the tender offer – purchased call options for Pillsbury stock, as well as shares of the stock. When Grand Met publicly announced its tender offer, the price of Pillsbury stock rose dramatically and O'Hagan sold his call options and stock at a profit of more than $4.3 million. O'Hagan was convicted of insider trading on the theory that he misappropriated from his law firm and its client, Grand Met, material, nonpublic information regarding the tender offer for Pillsbury and used it for his own trading purposes. The case was appealed all the way to the U.S. Supreme Court, which upheld the conviction and crystallized the misappropriation theory in the law.[23]

Note that O'Hagan was not an "insider" – or even a "temporary insider" – with respect to Pillsbury, the company whose securities were traded. O'Hagan's law firm represented Grand Met, not Pillsbury. Indeed, O'Hagan had no relationship to Pillsbury at all. However, O'Hagan was a partner of and therefore a fiduciary owing a duty of trust or confidence to his own law firm and to its client, Grand Met, which were the *source of the information* he misappropriated for his own trading purposes. Therefore, using the misappropriation theory, O'Hagan could be (and was) held liable for insider trading.

What other factors are important to the misappropriation theory of liability?

The misappropriation theory took many years to be clearly articulated by the courts and still stirs up controversy even though it is now well grounded in case law.[24] The theory certainly goes well beyond the usual thinking about insider trading by connecting the "fraud" or breach of duty to the *source of the inside information*, rather than to the company whose securities were traded, or even to other traders in the market.

Some will argue that this has created a "disconnect" between the insider trading laws – or at least the misappropriation theory – and the goal of protecting the integrity of the securities markets. They posit that it makes little sense to be protecting the market by enforcing against a breach of duty owed to *the source of the information* (such as the trader's employer, which may not be part of the "market" at all), rather than a breach of duty owed to the company whose securities are traded, the party on the other side of the trade or the marketplace as a whole. This "disconnect" was noted by the judge who sentenced Rajat Gupta, a former Goldman Sachs director who leaked inside information to fund manager Raj Rajaratnam in the now famous Galleon insider trading case. The judge said:

> "In the eye of the law, Gupta's crime was to breach his fiduciary duty of confidentiality to Goldman Sachs; or to put it another way, Goldman Sachs, not the marketplace, was the victim of Gupta's crimes as charged. Yet the [Sentencing] Guidelines assess his punishment almost exclusively on the basis of how much money his accomplice [Rajaratnam] gained by trading on the information. At best, this is a very rough surrogate for the harm to Goldman Sachs."[25]

Others take the opposite viewpoint, citing cases like the one discussed above involving Grand Met and Pillsbury and arguing that it would be unfair to hold the lawyer O'Hagan liable if he worked for the target company Pillsbury or its law firm as an "insider" or "temporary insider" using the classic theory, but not if he worked for the acquiror Grand Met or its law firm, which would require using the misappropriation theory and grounding his liability in the breach of duty owed to his law firm and client. Either way, they would point out, the breach of duty involved in misappropriating information constitutes a wrongful, deceitful act (that is, a "fraud") and results in an informational advantage that other traders in the marketplace cannot overcome by mere research or skill. Consequently, the anti-fraud laws should be available as an appropriate remedy to protect market integrity and promote investor confidence.

To be clear, the insider trading laws are not aimed at evening out every informational disparity. A trader's informational edge derived from legitimate research or from superior acumen or skill is not subject to sanction. However, when an informational edge derives from wrongful conduct that is deceitful or "fraudulent" – such as "misappropriation" in breach of a duty – then the anti-fraud provisions can be invoked to avoid that informational edge being used to the trader's advantage.

Derivative and Secondary Liability

Aside from the classic insider or misappropriator who may be *primarily* liable for insider trading, others may also be liable *derivatively* or *secondarily* in any given case.

What is tipper/tippee liability?

Tipper/tippee liability is a common derivative form of insider trading liability. Anyone who trades on a tip (referred to a "tippee") containing MNPI can be derivatively liable for insider trading, along with the person who gave them the tip (referred to as the "tipper"). Tipper/tippee liability prevents violators from circumventing the law by not trading directly but rather simply tipping someone else who trades instead. Under case law, [26] for a *tipper* to be liable it must generally be shown that: (1) the tipper disclosed MNPI in breach of a fiduciary or similar duty of trust or confidence; and (2) the tipper received a direct or indirect personal benefit as a result of the disclosure. A *tippee* is generally liable only if: (1) the tipper breaches a fiduciary or similar duty; and (2) the tippee knows (or should have known) that the disclosure constituted a breach.

The personal benefit element of tipper liability is intended to help distinguish wrongful, culpable disclosures from unintentional or innocent disclosures that do not justify the imposition of liability, although courts have weakened that element over the years. According to case law, the personal benefit received by the tipper need not be financial or even tangible. Indeed, it may be as ephemeral as a boost to personal reputation or the benefit that derives from having provided a gift to a relative or friend.[27] For example, the former Goldman Sachs director who was convicted of tipping Raj Rajaratnam reportedly did not profit directly from the tipping but viewed it as opening doors to future business opportunities.[28]

On the other hand, the personal benefit requirement could shield a tipper from liability if the disclosure is made with no intention to benefit anyone and for a purpose completely unrelated to trading.[29] If the tipper is shielded from liability, so would be the tippee since the tippee's liability is derivative.

What is controlling person liability?

'Controlling person' liability is a type of secondary liability that can be imposed in insider trading cases. Section 20(a) of the Exchange Act imposes joint and several liability on anyone who 'controls' another person who commits a violation of the Exchange Act, including insider trading. This is a leading provision grounding 'controlling person' liability claims in insider trading cases, not only against corporations and their officers and directors, but also against others who may have been in a position to prevent violations, such as outside accountants, underwriters and lawyers. Liability can be avoided if the control person "acted in good faith" and did not "directly or indirectly induce the act" constituting the violation.

Under Section 21A(a)(3) of the Exchange Act, a controlling person may be civilly liable to the SEC for an insider trading violation by a controlled person for the greater of (i) $1.425 million (as adjusted for inflation), or (ii) three times the amount of the profit gained or loss avoided as a result of the violation, if the SEC establishes that the control person knew or recklessly disregarded the fact that the controlled person was likely to engage in the acts constituting the violation and failed to take appropriate steps to prevent the acts before they occurred. 'Controlling persons' can include employers, as well as any other person with the power to influence or control the direction or the management, policies or activities of another person.[30]

What is aiding and abetting liability?

Aiding and abetting is another type of secondary liability that can be imposed in insider trading cases. Under Section 20(e) of the Exchange Act, anyone who knowingly provides "substantial assistance" to another person in violation of the Exchange Act is deemed to be in violation to the same extent as the person to whom the assistance was provided. This might come up in an insider trading case, for example, if a company discovered an insider who traded on or tipped MNPI outside of the company and did not take appropriate steps to stop it or, worse yet, helped to facilitate it or cover it up.

Sanctions and Consequences

What sanctions are available for insider trading violations?

Many types of sanctions are available for insider trading violations, depending on the forum involved (administrative proceeding, civil court, criminal court, etc.), the party charged (insider, tippee, control person, etc.), the mental state shown (mens rea, scienter based on recklessness, etc.) and similar factors. Among them are:

- prison sentences,
- disgorgement orders,
- fines and monetary penalties (including treble damages, over and above the disgorgement of profits gained or losses avoided),
- injunctions,
- collateral bars or suspensions from serving in the financial services industry,
- permanent or temporary bars from serving as corporate officers and directors,
- censures,
- cease-and-desist orders,
- asset freezes and contempt of court orders,
- orders requiring compliance consultants to review and recommend enhancements to internal policies and procedures, and
- damages and civil penalties in private lawsuits.

Preventing Insider Trading

What might regulators do to help prevent insider trading?

Regulators can and do use various methods to help prevent insider trading, including:

- *Robust enforcement*. The SEC continues to treat insider trading enforcement as a priority.[31]
- *Surveillance*. Virtually every major exchange has trading surveillance systems in place aimed at helping to identify illegality such as fraud, abuse, manipulation and insider trading.
- *Public education*. The SEC is actively involved in public education and has an office dedicated to this effort, known as the Office of Investor Education and Advocacy. That office has a website aimed at retail investors and routinely posts information alerting investors to issues of concern, including insider trading.[32] The North American Securities Administrators Association (NASAA), whose membership consists of securities regulators from the 50 states and other jurisdictions, also maintains an Investor Education section on its website, as do other governmental, regulatory and self-regulatory organizations.
- *Regulatory requirements*. Financial industry firms like investment advisers and broker-dealers are required to adopt internal procedures aimed at preventing illegality like insider trading and to supervise and monitor their personnel toward that end.[33] Regulators take these requirements seriously and have brought enforcement actions when firms failed to adopt reasonable insider trading procedures even when there has been no allegation of actual insider trading.[34]
- *Inspection of regulated entities*. Insider trading prevention procedures at regulated firms like advisers and brokers are subject to inspection by the SEC or other government regulators as part of the firm's overall compliance program.

What might companies do to help prevent insider trading?

In light of the potential exposure to 'controlling person' liability for insider trading committed by their personnel, companies often adopt insider trading procedures aimed at preventing, detecting and correcting violations. A sample Insider Trading Policy is located in the "Forms, Templates, Tools" section of this issue. Although the sample is designed for an investment advisory firm, insider trading controls are often implemented at other types of firms as well, including publicly-traded companies outside of financial services and other organizations where insider trading may be a particular risk.

A robust compliance program evidences that the company acted in good faith and did not induce any violation committed by company personnel. This could help in defending a Section 20(a) controlling person claim leveled at the company in an insider trading case. A robust compliance program could also help to counter any Section 21A claim alleging that the company acted with reckless disregard or failed to take appropriate steps to prevent violations before they occurred, or any aiding and abetting claim alleging that the company was complicit in or assisted the violation.

Elements of a robust compliance program might include:

- Written policies and procedures to maintain, for example, information barriers,[35] information sharing protocols and documentation, watch lists or restricted lists, personal trading restrictions and the like, aimed at preventing violations such as insider trading;
- Reporting requirements for appropriate personnel to report their personal trading internally, as part of a system aimed at detecting violations;
- Surveillance, testing and monitoring of the personal trading of appropriate personnel, aimed at measuring the effectiveness of the controls in place and identifying violations, issues, anomalies or suspicious patterns; and
- Training and education for appropriate personnel as to what the law requires and how it applies in their circumstances.

New Developments

Several noteworthy developments in the law of insider trading have occurred in the last few years, in connection with the Galleon/Rajaratnam case and others discussed below.[36]

How have "expert networks" been implicated in recent insider trading cases?

An investigation growing out of the Galleon/Raj Rajaratnam case brought to light insider trading violations facilitated by so-called "expert networks," firms that connect clients – such as investors, hedge fund managers, analysts, consultants and other decision-makers – with experts who are paid often very large fees to provide those clients with information, analysis, context, opinion or insight in their respective areas of expertise.

The SEC has now charged some 23 defendants in enforcement actions arising from its expert networks investigation, alleging that communications in certain cases involved the passing of inside information used for trading in violation of the insider trading laws.[37] Indeed, the largest insider trading case ever charged by the SEC – at $276 million – was based on communications conveyed through an expert network.[38] As a result, some companies now prohibit their personnel from using expert networks, or permit them to be used only in 'chaperoned' or recorded conversations or subject to other controls aimed at preventing the illegal communication and misuse of inside information.

What other new developments emerged from the Galleon/Rajaratnam case?

Aside from its sheer size, the Galleon case is noteworthy because of the government's unprecedented and aggressive tactics, including the use of wiretaps to investigate the case, which became the source of key evidence against Rajaratnam as well as the basis for pursuing numerous additional defendants in other insider trading cases. While it is not uncommon for wiretaps to be used to prosecute crimes such as terrorism, racketeering and drug smuggling, wiretaps are rarer in cases of white collar crime and, before the Galleon case, had reportedly never been used to prosecute insider trading.[39]

Even though appeals have been filed challenging the wiretaps used in Galleon, those appeals do not challenge the fundamental use of wiretaps in insider trading cases. Therefore, even if an appeal is successful in Galleon, wiretaps may well continue to be used to investigate other insider trading cases, particularly in large-scale, intricately webbed cases that would be difficult to investigate through other means. The SEC has continued to use other aggressive tactics to combat suspected insider trading as well, such freezing assets in foreign accounts of unknown traders, which requires the traders to make a court appearance to explain their suspicious trading if they want access to their trading proceeds.[40]

I heard Congress is "exempt" from the insider trading laws. Is that true?

Following troubling reports about whether members of Congress can trade on the basis of nonpublic information learned in their official capacities, the question resurfaced as to whether Congress is "exempt" from the insider trading laws.[41] Although Congress does not appear to be "exempt" from those laws, it has not been clear historically how those laws would apply to lawmakers with respect to information learned in the course of their public service.[42]

In response to this uncertainty and the resulting public outcry, Congress enacted the STOCK Act (the Stop Trading on Congressional Knowledge Act) in 2012, which expressly prohibits members and employees of Congress from using "any nonpublic information derived from the individual's position… or gained from performance of the individual's duties, for personal benefit." The Act also declares that members and employees owe a duty arising from a relationship of trust and confidence to Congress, the U.S. government and U.S. citizens with respect to nonpublic information derived from their official positions. Ostensibly, then, members and their employees could be held liable under the misappropriation theory of insider trading liability if they breach that duty of trust or confidence and trade on the basis of MNPI learned in their official position. Significantly, the STOCK Act also establishes a reporting requirement for certain individuals – including members of Congress – who must file public reports about securities and other financial transactions they engage in that meet certain criteria, perhaps on the theory that sunlight is the best disinfectant.

For now, the STOCK Act has dispelled the notion that Congress is "exempt" from insider trading laws. However, attention may well focus on this question again in the future as a result of hard to quell suspicions about the advantages of political knowledge and power.

Conclusion

An unprecedented number of insider trading cases continue to make the news and shine the spotlight on this area of the law. This article answers basic questions about insider trading that every compliance professional should know, from the definition of insider trading to the principal theories of liability, the potential consequences for violation and common methods aimed at prevention. Armed with this information, compliance professionals can function more effectively in today's enforcement environment.

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The information in this article is provided strictly as a courtesy to readers for educational purposes. It does not constitute legal advice, nor does it establish or further an attorney-client relationship. All facts and matters reflected in this article should be independently verified and should not be taken as a substitute for individualized legal advice.

ENDNOTES

1 See "The Insider Trading Debate," by Jie Hu and Thomas N. Noe, in Federal Reserve Bank of Atlanta, Economic Review, Fourth Quarter 1997, at 34: "A substantial body of academic and legal scholarship questions whether insider trading is even harmful, much less worthy of legal action."

2 See the "Objectives and Principles of Securities Regulation" dated May 2003, published by the International Organization of Securities Commissions (IOSCO), at Section 13.6: "The regulation of trading in the secondary market should prohibit market manipulation, misleading conduct, insider trading and other fraudulent or deceptive conduct which may distort the price discovery system, distort prices and unfairly disadvantage investors." Securities regulators from more than 100 jurisdictions are IOSCO members. For more on the history and international treatment of insider trading, see "Insider Trading – A U.S. Perspective," Remarks by Thomas C. Newkirk, Associate Director, SEC Division of Enforcement, and Melissa A. Robertson, Senior Counsel, SEC Division of Enforcement, at the 16th International Symposium on Economic Crime, Jesus College, Cambridge, England (September 19, 1998).

3 According to Rule 10b5-1 under the Exchange Act, trading "on the basis of" information essentially means while "aware of" the information.

4 This is consistent with the "in a nutshell" definition of insider trading offered by Linda Chatman Thomsen, Director, SEC Division of Enforcement, speaking at the Australian Securities and Investments Commission 2008 Summer School: U.S. Experience of Insider Trading Enforcement, Melbourne, Australia (February 19, 2008).

5 For a recap of the development of insider trading case law, see William E. Donnelley, "The Importance of Implementing an Effective Insider Trading Policy," *Practical Compliance and Risk Management for the Securities Industry* (May-June 2008) at 6-7.

6 See, for example, *The People of the State of New York v. Carlo Florentino,* Criminal Court of the City of New York, County of New York, Docket No. 1N060051 (November 16, 1982), where the State of New York brought insider trading charges against a defendant under the New York state Blue Sky law known as the Martin Act.

7 For example, Section 20A of the Exchange Act gives contemporaneous traders an express private right of action against anyone who trades while in possession of MNPI. Plaintiffs may also have private rights of action against those who engage in insider trading under Rule 10b-5, aside from the contemporaneous trader situation. See, for example, Anheuser-Busch Co. v. Thayer, CA3-856794-R (N.D. Texas 1986).

8 *Matrixx Initiatives, Inc. v. Siracusano*, 131 S. Ct. 1309 (2011) (*Matrixx*), citing *Basic, Inc. v. Levinson*, 485 U.S. 224, 231-32 (1988) (*Basic*).

9 See, *Matrixx*, *supra*.

10 *Basic*, *supra* note 8, citing *SEC v. Texas Gulf Sulphur Co*., 401 F.2d 833, 862 (2d Cir. 1968) (en banc), cert. denied sub nom. *Coates v. SEC*, 394 U.S. 976 (1969) (*Texas Gulf Sulphur*).

11 SEC Staff Accounting Bulletin No. 99 (SAB 99). See also In the Matter of Michael R. Pelosi, Initial Decision Release No. 448 (January 5, 2012) (citing *Basic*,

administrative law judge rejected 1% or 2% formulaic approach to "materiality" and instead used a more holistic, fact-specific approach).

12 SAB 99, *supra*.

13 Final Rule: Selective Disclosure and Insider Trading, Release Nos. 33-7881, 34-43154, IC-24599 (August 15, 2000).

14 In re Investors Management Co., 44 SEC 633, 643 (1971), citing *Texas Gulf Sulphur Co*., *supra* note 10.

15 See sources cited in Robert A. Prentice, "The Internet and Its Challenges for the Future of Insider Trading Regulation," 12 Harvard J. Law & Tech. 263, 276 (Winter 1999) (Prentice).

16 This is a common standard adopted for corporate insider trading policies. See, for example, the Cangene Insider Trading Policy at http://www.cangene.com/_uploads/documents/20%200%2001%20-%20Corporate%20Disclosure%20Policy.pdf, or the Phoenix New Media policy at http://media.corporate-ir.net/media_files/irol/24/242799/Exhibit%20G%20-%20Insider%20Trading%20Policy.pdf.

17 For a more complete discussion of this issue, see generally Prentice, *supra* note 15.

18 A summary of the SEC case against Waksal is available here: http://www.sec.gov/litigation/litreleases/lr19039.htm. Allegations of the same nature grounded the government's criminal case against Waksal. The ImClone case also embroiled celebrity Martha Stewart, who also sold ImClone stock prior to the FDA announcement, although Stewart's criminal conviction was for obstruction of justice and not for insider trading based on the classic theory of liability.

19 *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976). For a discussion of how courts have applied the Hochfelder case, see Jeanne P. Bolger, "Recklessness and the Rule 10b-5 Scienter Standard After Hochfelder," 49 Fordham L. Rev. 817 (1981).

20 See letter to the SEC from the Council of Institutional Investors, dated December 28, 2012, regarding Rule 10b5-1 Plans, available at http://www.sec.gov/rules/petitions/2013/petn4-658.pdf. See also *SEC v. Manouchehr Moshayedi*, Docket No. 8:12-CV-01179 (USDC C.D.Cal.) (July 19, 2012).

21 For other examples, see the Chiarella, Newman, Clark and Carpenter cases discussed in Randall W. Quinn, "The Misappropriation Theory of Insider Trading in the Supreme Court: A (Brief) Response to the (Many) Critics of United States v. O'Hagan," 8 Fordham J. of Corp. & Fin. L. 865 (2003) (Quinn). Although the U.S. Supreme Court has not settled exactly what types of relationships suffice to establish the duty of trust or confidence required by the misappropriation theory, various cases state or imply that attorney-client, doctor-patient and employer-employee relationships are "inherently fiduciary" and would suffice. See Quinn at 887, citing *United States v. Chestman*, 947 F.2d 551 (2d Cir. 1991).

22 Rule 10b5-2 under the Exchange Act.

23 *United States v. O'Hagan*, 521 U.S. 642 (1997) (O'Hagan).

24 For a history and analysis of the misappropriation theory, see Quinn, *supra* note 21.

25 Judge Jed S. Rakoff's, Sentencing Memorandum and Order in *U.S. v. Gupta*, 11 Cr. 907 (JSR) (SDNY) (October 24, 2012) (Gupta Sentencing Memo) at 6.

26 See *Dirks v. SEC*, 463 U.S. 646 (1983) (Dirks). Note that Dirks and its progeny are not completely consistent from circuit to circuit.

27 See *SEC v. Warde*, 151 F.3d 42 (2d Cir. 1998), citing *Dirks*, *supra* note 26.

28 See Gupta Sentencing Memo, *supra* note 25 at 2, 12: "[Tipper] Mr. Gupta did not in any direct sense receive one penny….But…there is no doubt that Gupta, though not immediately profiting from tipping Rajaratnam, viewed it as an avenue to future benefits, opportunities, and even excitement."

29 See, for example, *Dirks*, *supra* note 26, where the tippers received no monetary or personal benefit for revealing corporate secrets, nor was their purpose to make a gift of valuable information to the tippee. Rather, the tippers were motivated by a desire to expose a corporate fraud.

30 For a more complete discussion of Section 20(a) liability, see Erin L. Massey, "Control Person Liability Under Section 20(a): Striking a Balance of Interests for Plaintiffs and Defendants," 6 Hous. Bus. & Tax L. J. 109 (2005); and Ralph C. Ferrara and Diane Sanger, "Derivative Liability in Securities Law: Controlling Person Liability, Respondeat Superior, and Aiding and Abetting, 40 Wash. & Lee L. Rev. 1007 (1983).

31 See SEC Enforcement Actions: Insider Trading, at http://www.sec.gov/spotlight/insidertrading/cases.shtml, which contains a summary of more than 40 insider trading cases brought by the SEC in the last few years.

32 See the website at http://investor.gov/ and the information posted on insider trading at http://www.sec.gov/answers/insider.htm. See also the SEC spotlight on insider trading at http://www.sec.gov/spotlight/insidertrading.shtml.

33 See Section 15(g) of the Exchange Act (broker-dealers) and Section 204A of the Investment Advisers Act of 1940 (investment advisers). Registered investment companies often adopt similar procedures under Rule 17j-1 and/or 38a-1 of the Investment Company Act of 1940.

34 See In the Matter of Janney Montgomery Scott, LLC, Exchange Act Release No. 64855 (July 11, 2011) (settled); and In the Matter of Buckingham Research Group, et al., Exchange Act Release No. 63323 (Nov. 17, 2010) (settled).

35 For a more complete discussion of the controls restricting MNPI in place at broker-dealer firms, see Staff Summary Report on Examinations of Information Barriers: Broker-Dealer Practices Under Section 15(g) of the Securities Exchange Act of 1934, by the staff of the SEC Office of Compliance Inspections and Examinations (September 27, 2012); and Broker-Dealer Policies and Procedures Designed to Segment the Flow and Prevent the Misuse of Material Nonpublic Information, a report of the SEC Division of Market Regulation (March 1990).

36 For a discussion of other trends in the law of insider trading, see John H. Sturc and Adam Chen, "Insider Trading: New Developments and How to Deal with Them," *Practical Compliance and Risk Management for the Securities Industry* (Nov-Dec 2011) at 15-20.

37 See the June 26, 2012 SEC press release at http://www.sec.gov/news/press/2012/2012-121.htm announcing the case against Tai Nguyen, owner of Insight Research, and summarizing the cases brought to date as a result of the investigation.

38 *SEC v. CR Intrinsic Investors, LLC, Mathew Martoma and Dr. Sidney Gilman*, USDC SDNY, 12 Civ. 8466 (Complaint filed November 20, 2012), was the largest ever charged by the SEC as of that date.

39 "Rajaratnam Slams Wiretaps, Cites Analysts in Defense (Update3)," on Bloomberg (November 24, 2009) at http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aCd7aWI9cAsY.

40 See, for example, *SEC v. Certain Unknown Traders in the Securities of H.J.Heinz Company*, USDC SDNY, 13 Civ. 1080 (Complaint filed February 15, 2013).

41 See, for example, the CBS News report aired November 13, 2011, on "60 Minutes" entitled "Congress: Trading stock on inside information?"

42 See testimony of Robert Khuzami, Director of the SEC's Division of Enforcement, before the Committee on Financial Services of the U.S. House of Representatives (December 6, 2011).