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Insider Trading In Light Of The Economic Crackdown

Law360, New York (November 10, 2009) -- On October 16, 2009, federal prosecutors and the SEC filed charges against Raj Rajaratnam, the founder and portfolio manager of Galleon Group, a hedge fund based in New York, and five other individuals for unlawful insider trading.

On November 5, 2009, federal prosecutors and the SEC filed charges against an additional nine defendants.

This highly publicized interest in insider trading will continue and ensnare a growing number of individuals and entities. The purpose of this guest column is to provide a brief overview of the law of insider trading.

The primary federal securities law provision implicated by insider trading is the general prohibition on securities fraud set forth in Exchange Act Rule 10b-5, which provides that "[i]t shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange," to "employ any device, scheme, or artifice to defraud" or "engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security." 17 C.F.R. § 240.10b-5 (2009).

The courts have held that Rule 10b-5 does not impose "a general duty between all participants in market transactions to forgo actions based on material, nonpublic information." Chiarella v. United States, 445 U.S. 222, 233 (1980).

As such, the courts have developed two theories of insider trading: (1) the "traditional" or "classical" theory and (2) the "misappropriation" theory. The two theories are complementary, each addressing efforts to capitalize improperly on material, nonpublic information through the purchase or sale of securities.

In general, the “classical” theory prohibits an insider (such as a corporation’s officers, directors, employees, counsel, auditors and advisers) from trading in the corporation’s securities on the basis of material, nonpublic information that the insider obtained pursuant to the insider’s relationship of trust and confidence with the corporation that issued the stock.

In an apparent gloss on the classical theory, the Second Circuit recently held that an individual with no prior relationship to an issuer can commit unlawful insider trading if the individual obtains material, nonpublic information from the issuer through affirmative misrepresentation.

In SEC v. Dorozhko, 2009 WL 2169201 (2d Cir., July 22, 2009), the Second Circuit held that a computer hacker who obtained material, nonpublic information by gaining access to a secure computer server could have violated Rule 10b-5 by trading based on that information if the hacker employed an affirmative misrepresentation in gaining access.

In general, the “misappropriation” theory prohibits any person from trading in a corporation’s securities on the basis of material, nonpublic information that the person obtained pursuant to a relationship of trust and confidence owed to the source of the information.

Affirming the misappropriation theory, in 1997, the Supreme Court upheld the conviction of James O’Hagan, a former partner at a law firm who purchased call options for the common stock of Pillsbury based on information that the law firm had received from a client, Grand Met, that Grand Met might make a tender offer for Pillsbury’s common stock. United States v. O’Hagan, 521 U.S. 642 (1997).

The Supreme Court held that O’Hagan committed securities fraud because he breached duties owed to the law firm and to its client, Grand Met. Id. at 544 n. 6.

The leading case on tippee liability is the Supreme Court’s 1983 opinion in Dirks v. SEC, 463 U.S. 646 (1983). An insider of Equity Funding of America, a corporation primarily engaged in selling life insurance and mutual funds, informed an analyst, Raymond Dirks, that the assets of Equity Funding were vastly overstated because of fraud. Id. at 649.

The insider informed Dirks in order for Dirks to investigate the allegations and, once Dirks verified the allegations, disclose them publicly. Id.

During the course of his investigation, Dirks, who himself never traded any Equity Funding stock, discussed the allegations with clients who sold their Equity funding securities before the fraud was publicly disclosed. Id.

The SEC charged Dirks with, among other federal securities law violations, insider trading in violation of Rule 10b-5. Dirks appealed to the Supreme Court, which rejected the SEC’s charge. Id. at 667.

The Supreme Court declined to decide whether the information the insider provided to Dirks was material but held that not all disclosures of material, nonpublic information constitute a breach. Id. at 661-62.

Whether or not disclosure is a breach depends on the purpose of the disclosure. Id. at 662. If the purpose of the disclosure is so that the insider may obtain a direct or indirect personal benefit, then a breach has occurred. A personal benefit need not be specific or tangible and can, in fact, be intent to benefit the tippee. Id. at 663-64.

Absent a personal benefit, there is no breach by the insider, and, absent a breach by the insider, there is no derivative breach by the tippee. Id. at 662. The tippee's duty to abstain from trading, therefore, is derived from the insider's duty and the "tippee assumes a fiduciary duty to the shareholders of a corporation not to trade on material nonpublic information only when the insider has breached his fiduciary duty to the shareholders by disclosing the information to the tippee and the tippee knows or should know that there has been a breach." Id. at 660.

As articulated by the Second Circuit, a tippee may be found liable under Section 10(b) if: (1) the tipper possessed material, nonpublic information; (2) the tipper disclosed this information to the tippee; (3) the tippee traded while in possession of the material, nonpublic information provided by the tipper; (4) the tippee knew or should have know that the tipper violated a relationship of trust by relaying the information; and (5) the tipper benefited from the disclosure. SEC v. Warde, 151 F.3d 42, 47 (2d Cir. 1998).

Also, as the Supreme Court noted in Dirks, "Scienter — 'a mental state embracing intent to deceive, manipulate, or defraud,' Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 n. 12 (1976) - is an independent element of a Rule 10b-5 violation." 463 U.S. at 664 n. 23.

Other applicable federal securities law provisions include Rule 14e-3(a) and Regulation FD. Rule 14e-3(a) prohibits trading in securities on the basis of material, nonpublic information concerning a pending tender offer that the trader knows or has reason to know has been acquired "directly or indirectly" from an insider of the offeror or issuer, or someone working on their behalf. 17 C.F.R. § 240.14e-3 (2009).

The Second Circuit has held that Rule 14e-3(a) creates a duty in those traders who fall within its ambit to abstain from trading or publicly disclose, without regard to whether the trader owes a pre-existing fiduciary duty to respect the confidentiality of the information. United States v. Chestman, 947 F. 2d 551, 557 (2d Cir. 1991) (en banc).

Regulation FD prohibits selective disclosure of material, nonpublic information by issuers. Regulation FD provides that when an issuer, or someone working on its behalf, discloses material, nonpublic information to certain enumerated persons (generally securities market professionals and holders of the issuer's securities who may trade on the basis of the information), the issuer must make public disclosure of that information.

If an issuer has a policy limiting which senior officials are authorized to speak on behalf of the issuer, then Regulation FD does not apply to selective disclosure of material, nonpublic information made by the issuer's personnel who are not authorized to speak on behalf of the issuer.

In addition, Regulation FD does not prohibit an issuer from providing material, nonpublic information to an analyst if the recipient expressly agrees to maintain confidentiality until the information is publicly disclosed. 17 C.F.R. § 243.100 (2009).

In March 2008, the SEC issued a report of investigation "to remind investment managers, public and private, of their obligation to comply with the federal securities laws and the risks they undertake by operating without an adequate compliance program."[1]

The SEC can bring civil charges against entities and individuals for unlawful insider trading and against persons (such as employers) who control such entities and individuals. Controlling persons who fail to prevent insider trading may be subject to civil penalties under Exchange Act §21A.

Even in the absence of unlawful trading, the SEC can bring charges against registered broker dealers and registered investment advisers that fail to establish, maintain and enforce written policies and procedures reasonably designed to prevent the misuse of material, nonpublic information under Exchange Act §15(f) and Advisors Act §204A.

Federal prosecutors can bring criminal charges against entities or individuals for unlawful insider trading but must satisfy the heightened standards applicable to criminal prosecutions.

--By Kenneth B. Winer (pictured), Seth L. Levine and Brooke D. Clarkson, Foley & Lardner LLP

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The opinions expressed are those of the authors and do not necessarily reflect the views of Portfolio Media, publisher of Law360.

[1] Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The Retirement Systems of Alabama, Exchange Act Release No. 57446 (March 6, 2008), available at www.sec.gov/litigation/investreport/34-57446.htm