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Regulatory: Directors and officers and insider trading

An effective company policy can shield company executives from insider trading liability

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Recent Securities and Exchange Commission (SEC) enforcement actions demonstrate the SEC's willingness to impose personal liability on directors and officers of public companies who fail to take appropriate steps to prevent securities law violations by subordinates. In light of these enforcement actions and recent enforcement actions for insider trading violations, directors and officers should take extra care to ensure that their companies institute a policy against insider trading and closely monitor its effectiveness.

Federal securities law imposes personal liability on "controlling persons" who fail to take appropriate steps to prevent or detect securities law violations by their subordinates. Directors and officers of a public company are generally deemed to be controlling persons and are charged with a responsibility to enforce the company's policy against insider trading, a responsibility that the SEC has demonstrated an increasing willingness to enforce.

All of this should put a little fear in directors and officers because insider trading allegations can spell big trouble for a company. However, the good news is that with an effective policy against insider trading in place, it is likely insider trading violations will be avoided. In addition, a policy against insider trading that directors and officers actively oversee and monitor for effectiveness will insulate them from personal liability in the event an employee engages in insider trading.

An effective policy against insider trading begins with education. Directors, officers and employees need to learn that federal securities law prohibits not only them, but also their family members, relatives and related persons from buying or selling company common stock while aware of material, nonpublic information about the company (so-called "inside information").

Another area for education relates to sharing inside information with others, as some directors, officers and employees view this as a less serious problem. They mistakenly think of "tipping" or communicating inside information as less serious because they are not using the inside information to buy or sell company stock. So, directors, officers and employees need to be taught that "tipping" is considered a violation of insider trading laws, and they will be as liable as the person to whom they provide the inside information if that person uses the information to buy or sell company stock. This is true even if the director, officer or employee is not involved with and did not profit from the trading by the person with whom he shared the information.

A final area for education is the severity of the penalties that can be imposed, and the harm that they can bring to the company. Individuals trading on or passing on inside information to others are subject to severe criminal sanctions and civil penalties of up to 300 percent of the profit gained or loss avoided. At the company level, insider trading allegations bring with them substantial reputational harm that can disrupt the market for the company's stock, and regulatory investigations that are costly and distracting.

In addition to educating themselves and employees about insider trading, directors and officers need to ensure that they thoroughly review and understand the company policy against insider trading, including the mechanics of pre-clearing transactions, trading windows and the roles of the officers tasked with monitoring and implementing the policy. Directors and officers also should have an annual review session with the general counsel or outside counsel where they are updated on recent developments and where they have an opportunity to ask questions or raise concerns.

About the Author

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