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WHAT A CCO CAN DO TO REDUCE THE RISK OF INSIDER TRADING

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WHAT A CCO CAN DO TO REDUCE THE RISK OF INSIDER TRADING – THE BASICS

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I. <u>Introduction</u>.

A. "Insider trading" is commonly defined as the practice of buying or selling shares of stock (or options for such stock) while in knowing possession of material nonpublic information about the issuing corporation or the trading market for its stock. "Tipping" refers to the practice of communicating such material nonpublic information to another person who then purchases or sells the stock (or options). By communicating such information, the tipper seeks to do indirectly (*i.e.,* through tipping) that which he or she cannot do directly (*i.e.,* engage in insider trading).

B. It is abundantly clear that insider trading and tipping violate the antifraud provisions of the federal securities laws and, depending upon the circumstances, may:

1. Expose the wrongdoers and their "controlling persons" (including employers) to:

    a. SEC enforcement investigations, administrative proceedings, and lawsuits;

    b. Unwanted publicity, embarrassment, and bars from serving as a director or officer of a public company;

    c. Lawsuits brought by private plaintiffs, under both express and implied private rights of action, seeking damages;

    d. Civil fines of up to three times the profit gained or loss avoided by the wrongdoers (or, in the case of "controlling persons," the *greater* of $1 million or three times the profit gained or loss avoided by the wrongdoers); and

    e. Criminal investigations, convictions, and sanctions, including substantial criminal fines and (in the case of individuals) prison sentences.

2. Give rise to a duty on the part of the corporation that issued the stock to which the insider trading and tipping relate to make public disclosures earlier than that duty might otherwise arise under the federal securities

laws, with possible resulting liability under Regulation FD or under the "fraud-on-the-market" theory if the corporation breaches such a duty.

3. Restrict or "sterilize" trading by investment management organizations where their portfolio managers, analysts or other employees come into knowing possession of material nonpublic information (or they are deemed to) in connection with such insider trading or tipping in certain circumstances.

C. Nevertheless, the law and underlying theory of insider trading and tipping have numerous nuances and subtleties that complicate their application to specific factual situations. Accordingly, it is important to understand how the SEC and the federal courts have reached the conclusion that insider trading and tipping violate certain of the antifraud provisions of the federal securities laws, including Sections 10(b) and 14(e) of the Securities Exchange Act of 1934 (the "Exchange Act") and, particularly, Rules 10b-5 and 14e-3 thereunder.

II. <u>Elements for Liability under Rule 10b-5</u>. Rule 10b-5, which is the primary source of federal insider trading law, provides that it is unlawful to "make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading," or to engage in any fraud or deceit, in connection with the purchase or sale of any securities. So stated, liability under Rule 10b-5 requires a variety of elements, of which the following bear upon the current discussion:

A. <u>Untrue Statement or Failure to State Fact Necessary to Render Other Statements Made Not Misleading</u>. This element embraces lies and so-called "half-truths." These are sins of commission (in that they involve some sort of affirmative statement or representation), rather than pure omission (or silence). This is the key to the so-called "duty" analysis.

B. <u>Intent – and Possession versus Use</u>. The defendant must have acted with *scienter* or intent – a "mental state embracing intent to deceive, manipulate or defraud."[1] The contours of this required mental state remain unclear, however. While more than "mere negligence" is required,[2] "recklessness" probably is sufficient, although the Supreme Court has not yet definitively resolved this issue.[3] In the insider trading context, it is unclear whether the *scienter* requirement of Rule 10b-5 requires proof that the defendant traded *on the basis of* material nonpublic information; as the SEC has long asserted, it may be sufficient that the defendant traded *while in knowing possession of* material nonpublic information which he did not disclose.[4] Some courts have required evidence that the defendant actually "used" the material, non-public information in making the decision to trade.[5] The SEC, in adopting Rule 10b5-1 in 2000, reaffirmed its position that knowing possession of information is sufficient. Specifically, Rule 10b5-1 provides that for purposes of insider trading, awareness of the material, non-public information when making a trade is sufficient for liability to attach.[6]

C. Materiality. Generally speaking, information is deemed "material" where there is a substantial likelihood that a reasonable shareholder would consider the information important in deciding whether to buy or sell the securities in question, or where the information, if disclosed, would be viewed by a reasonable investor as having significantly altered the "total mix" of information available.[7] Where the nonpublic information relates to a possible or contingent event, materiality depends upon a balancing of both the probability that the event will occur and the anticipated magnitude of the event in light of the totality of the circumstances.[8] Common, but by no means exclusive, examples of "material" information include information concerning a corporation's sales, earnings, dividends, significant acquisitions, mergers, or tender offers, and major litigation. When adopting Regulation FD in 2000, the SEC refrained from articulating an exhaustive list of events that are more likely to be considered material, but noted that "the following items are some types of information or events that should be reviewed carefully to determine whether they are material: (1) earnings information; (2) mergers, acquisitions, tender offers, joint ventures, or changes in assets; (3) new products or discoveries, or developments regarding customers or suppliers (*e.g.*, the acquisition or loss of a contract); (4) changes in control or in management; (5) change in auditors or auditor notification that the issuer may no longer rely on an auditor's audit report; (6) events regarding the issuer's securities – *e.g.,* defaults on senior securities, calls of securities for redemption, repurchase plans, stock splits or changes in dividends, changes to the rights of security holders, public or private sales of additional securities; and (7) bankruptcies or receiverships."[9]

D. Nonpublic. "Nonpublic" information is information that is not generally available to investors in the marketplace: "Information is nonpublic when it has not been disseminated in a manner making it available to investors generally."[10] Under Regulation FD, information is not deemed publicly disclosed unless it is reported on a Form 8-K filed with the SEC or disseminated "through another method (or combination of methods) of disclosure reasonably designed to provide broad, non-exclusionary distribution of the information to the public."

III. <u>Overcoming Silence: The Search for a Duty to Speak</u>.

A. <u>Shortcomings of Rule 10b-5 as Applied to Insider Trading and Tipping</u>.

1. Rule 10b-5 does not, on its face, prohibit insider trading or tipping. Rather, Rule 10b-5 by its explicit terms prohibits only lies and "half-truths." Thus, the Rule itself imposes a federal duty to speak truthfully if anything is said or otherwise communicated, regardless of the existence of any fiduciary or other duty.[11] But, in most instances, insider trading occurs through "faceless," impersonal securities transactions and involves pure *silence* rather than any affirmative lies or "half-truths." In this circumstance, the possible legal sources of an obligation to overcome silence — *i.e.,* a duty to speak — are critical.

2. Thus, in the usual case, insider trading and tipping are unlawful under Rule 10b-5 *only* if they can be said to involve a fraudulent breach of a fiduciary or other duty to speak. As the Supreme Court stated in *Chiarella v. United States,* "what 10(b) catches must be fraud . . . [and] there is no fraud [in the case of silence] absent a duty to speak."[12] But, neither the Exchange Act nor Rule 10b-5 defines the term "fraud," even though that concept delimits the reach of Rule 10b-5.

B. <u>"Boot-Strapping" from State Common Law Principles</u>. As a result of the limitations of Rule 10b-5 in dealing with insider trading and tipping, the SEC and the federal courts have sought to expand the otherwise narrow proscriptions of Rule 10b-5 by looking to traditional state common law principles of fiduciary and other duties to speak — and essentially "boot-strapping" from those principles to create a federal cause of action for insider trading and tipping under Rule 10b-5. In other words, the SEC and the federal courts have borrowed state common law principles that give rise to a duty to speak, imported them into Rule 10b-5, and thus expanded the reach of the Rule to cover silence where it would otherwise apply only to lies and "half-truths." In this way, a purely state law breach of duty becomes a federal Rule 10b-5 violation.

1. <u>The Value of Information</u>. A central theme in those fiduciary and other duties that have been borrowed from state common law and imported into Rule 10b-5 is that information is a valuable commodity, as to which fiduciary and other duties attach and the rights to which are proprietary in nature.[13]

2. <u>Fiduciary and Other Duties</u>.

a. A pervasive principle at common law is that a person who occupies a fiduciary or other relationship of trust and confidence with another person owes that person an affirmative duty to act in good faith and to make full and fair disclosure of all material facts.[14] Stated another way, an affirmative disclosure obligation arises where one party has valuable information that the other party is entitled to know because of the existence of a fiduciary or other relationship of trust and confidence between them.[15]

b. Thus, in contrast to typical arms-length transactions, a person who occupies a fiduciary or other relationship of trust and confidence with another person commits fraud where he enters into a transaction with such other person without disclosing all material information in his or her possession.[16]

3. Misappropriation.

a. Moreover, since at common law confidential corporate information is viewed as a type of property, like any other piece of valuable corporate property, be it tangible or intangible, such information can be the subject of a misappropriation. As the Supreme Court stated in *United States v. O'Hagan*, "[a] company's confidential information . . . qualifies as property to which the company has right of exclusive use."[17] Accordingly, a person who acquires confidential information by virtue of an agency, fiduciary, or other relationship of trust and confidence with another is not free to misappropriate that information by converting it to his or her own personal gain.

b. As a general rule, neither party to an arms-length transaction has an obligation to disclose information to the other unless, as discussed above, the parties stand in some fiduciary or other relationship of trust and confidence. However, where one party has an informational advantage that was derived improperly through misappropriation or other unlawful means, that party has a duty to disclose that information to another party with whom he deals in order to, in essence, relinquish his or her ill-gotten informational advantage.[18]

c. At the same time the SEC adopted Rule 10b5-1 in 2000, it also adopted Rule 10b5-2 to clarify how the misappropriation theory applies to certain non-business relationships. Under the rule, a person receiving confidential information would owe a duty of trust or confidence and thus could be liable under the misappropriation theory if:

(i) the person agreed to keep information confidential;

(ii) the persons involved in the communication had a history, pattern, or practice of sharing confidences that resulted in a reasonable expectation of confidentiality; or

(iii) the person who provided the information was a spouse, parent, child, or sibling of the person who received the information, unless it were proven based on the facts and circumstances of the family relationship that there was no reasonable expectation of confidentiality.

C. The Emerging Theory of a Duty to Speak in Insider Trading and Tipping Cases under Rule 10b-5. The theory of insider trading and tipping that has evolved by reference to state common law principles of fiduciary and other duties is that a person violates Rule 10b-5 where he or she, while in possession of material nonpublic information about a corporation or the trading market for its shares of stock, buys or sells the stock — or tips another person who then trades — without disclosing that information and, by his or her silence, breaches a preexisting duty to speak. Under the so-called "disclose or abstain" rule, first established in *Cady Roberts & Co.,*[19] one who possesses material nonpublic information and has a duty to disclose it must either make full disclosure of such information prior to trading with the corporation's shareholders or abstain from trading in the corporation's stock.[20] Thus, the disclose or abstain rule poses a "Catch 22" for the wrongdoer: If he or she fails to disclose the material nonpublic information in his or her possession prior to trading in the corporation's stock, he or she may breach a state law duty to speak and, thus, violate federal Rule 10b-5; if he or she discloses that information prior to trading, he or she may breach a state law duty to maintain the information in confidence. As the following examples illustrate, the evolving duty analysis has been flexible enough to apply to a wide variety of circumstances:

1. The Corporation and Corporate Insiders. The corporation and corporate insiders owe a fiduciary duty of loyalty to the corporation's shareholders who are, for all practical purposes, beneficial owners of the corporation. This duty extends also to prospective shareholders; thus, the rule applies to both purchases from existing shareholders and sales to incipient shareholders.[21/]

a. The Corporation Itself. Corporations themselves have long been held to an obligation of full disclosure under Rule 10b-5, as well as under other provisions of the federal securities laws, such as Sections 11, 12(2), and 17(a) of the Securities Act of 1933 (the "Securities Act"), when they sell or repurchase their own stock. Thus, for example, where a corporation, which has yet to publicly announce material changes in its cash dividend policy, engages in a program to repurchase corporation stock for its incentive compensation and stock option plans, such conduct may be viewed as insider trading by the corporation in violation of a duty to the corporation's shareholders.[22]

b. Directors and Officers. Directors and officers are the easiest examples of corporate insiders. There is a long legal history of imposing fiduciary duties to the corporation and its shareholders upon those who control the daily activities of a corporation.[23]

c. Employees. Corporate employees are agents/servants of the corporation and are held to fiduciary duties of loyalty that include the obligation, rooted in the common law, not to profit from confidential information given to them in the course of their employment.[24]

d. Controlling Shareholders. Even though controlling shareholders may not serve as directors or officers of a corporation, they may be viewed as corporate insiders by virtue of the fact that they may have the same sort of fiduciary duties and access to confidential information as the typical director or officer.[25]

e. "Temporary" Insiders.

(i) Under certain circumstances, such as where material nonpublic corporate information is revealed legitimately to an underwriter, accountant, lawyer, consultant, or other professional working for a corporation, these "outsiders" may become "temporary insiders" of the corporation (and, thus, "quasi" fiduciaries of the corporation's shareholders). As the Supreme Court explained in *Dirks v. SEC,* "[t]he basis for recognizing this fiduciary duty is not simply that such persons acquired nonpublic corporate information, but rather that they have entered into a special confidential relationship in the conduct of the business of the enterprise and are given access to information solely for corporate purposes."[26]

(ii) In addition, where a nonprofessional "outsider" becomes privy to information that he knows or should have known was conveyed in confidence for a legitimate business purpose and he explicitly or implicitly agrees to keep such information confidential, he assumes the role of a "temporary insider" of the corporation.[27]

2. Tippees.

a. Distinguished From "Temporary" Insiders. Unlike "temporary" insiders, a "tippee" is a mere outside recipient of material nonpublic information, not someone who explicitly or implicitly agreed to keep the information confidential or who otherwise occupies a "quasi" fiduciary relationship with respect to the corporation. Accordingly, tippees can *only* be held liable for trading while in possession of such information by inheriting or assuming the duty owed by the corporate insider/tipper to his or her corporation and its shareholders. In this context, the tippee is viewed as a "participant, after the fact," in the insider/tipper's own breach of fiduciary duty.[28]

b. Standard for Liability. Under the Supreme Court's decision in *Dirks,* tippee liability requires proof that:

(i) The insider/tipper breached a fiduciary or other duty by disclosing the confidential information to the tippee for an improper purpose; and

(ii) The tippee knew or should have known that the tipper's communication constituted such a breach.[29]

c. Improper Purpose. In determining whether the insider/tipper disclosed the information for an improper purpose, the test is "whether the insider personally will benefit, directly or indirectly, from his disclosure."[30] In this context, personal benefit includes not only pecuniary benefits (*e.g.,* kickbacks or profit-sharing arrangements), but reputational and "ego" benefits as well.[31] In contrast, for example, where an insider discloses material nonpublic information in a conversation that is proper and the information is unintentionally overheard, the person overhearing that information does not inherit the insider's duty and may legally trade on that information unless he otherwise agrees to maintain the information in confidence (in which case he may become a temporary insider).[32]

d. Knowledge of Insider's Breach. The requirement that the tippee knew or should have known that the tipper's communication constituted a breach of a fiduciary or other duty does not mean that the tippee must have formed a legal judgment on the matter. For example, in the case of information tipped by a corporate insider, it should be enough that the tippee was aware that the information was confidential and was given to him without apparent corporate justification (thus, by process of elimination, serving some personal objective of the insider/tipper).[33] Application of this test is more difficult, however, in the case of a "remote" tippee who receives from his or her tipper material nonpublic information that has been transmitted through a chain of tips. Absent any evidence that the first-tier tippee/tipper explicitly or implicitly agreed to keep that information confidential, and given the attenuated passage of the information, it may be difficult to establish that the remote tippee knew or should have known that *his or her* direct tipper was breaching a fiduciary or other duty by communicating the information, or that the information retained any kind of confidentiality in the hands of the tipper.[34]

3. Misappropriators. Where a person owes no duty to the shareholders of a corporation as a traditional insider, "temporary" insider, or tippee, he may nonetheless be liable for insider trading or tipping under the so-called "misappropriation" theory.

    a. Misappropriation Theory of Insider Trading and Tipping. The misappropriation theory of insider trading and tipping was born of the need to reach insider trading and tipping in the tender offer context where the trader or tipper owed no fiduciary or other duty to the corporation in whose stock he traded (*i.e.,* the "target" of the tender offer) or that corporation's shareholders. Under the misappropriation theory, one who misappropriates someone else's information, converts it to his or her own personal use, and trades while in possession of that information — or communicates it to others who trade — violates Rule 10b-5. By misappropriating the material nonpublic information, the insider trader or tipper breaches a duty to the owner of that information (typically that person's employer); it is not necessary that the insider trader or tipper breach a duty owed to the corporation in whose stock he trades or that corporation's shareholders.[35]

4. Insider Trading and Tipping in the Tender Offer Context: Rule 14e-3 and the Creation of a Federal Duty to Speak. Rule 14e-3 supplements and broadens the insider trading and tipping prohibitions of Rule 10b-5 in the context of tender offers. Rule 14e-3, adopted by the SEC in 1980, seeks to address the same problem of trading or tipping by a non-fiduciary of the "target" corporation's shareholders as does the misappropriation theory. As discussed below, Rule 14e-3 does so by explicitly creating a federal duty to speak, rather than merely relying upon state common law principles (such as fiduciary duties or the misappropriation theory) as a source of such a duty. Indeed, the SEC's authority to adopt the Rule was challenged based principally on the breadth of activity covered by Rule 14e-3, compared to Rule 10b-5's reliance on duties and misappropriations. However, the Supreme Court upheld the SEC's authority in *United States v. O'Hagan*.[36]

a. Rule 14e-3's Prohibitions. Rule 14e-3 contains two prohibitions:

(i) Rule 14e-3(a) provides that, "if any person has taken a substantial step or steps to commence, or has commenced, a tender offer . . . [no] other person who is in possession of material information relating to such tender offer which information he knows or has reason to know is nonpublic and . . . has been acquired directly or indirectly from (1) the offering person, (2) the issuer of the securities sought or to be sought by such tender offer, or (3) any officer, director, partner or employee of any other person acting on behalf of the offering person or such issuer, [may] purchase or sell or cause to be purchased or sold any of such securities"; and

(ii) Rule 14e-3(d) prohibits certain persons from communicating material nonpublic information relating to a tender offer to any other person under circumstances in which it is reasonably foreseeable that such communication is likely to result in a violation of Rule 14e-3(a). Persons who are subject to the Rule's anti-tipping provisions include:

(a) tender offerors;

(b) targets;

(c) officers, directors, partners, employees, and advisors of either the tender offeror or the target;

(d) anyone acting on behalf of the offeror or the target; and

(e) any person in possession of material nonpublic information relating to a tender offer which he knows or has reason to know is nonpublic or has been acquired directly or indirectly from the offeror or the target.

b. Rule 14e-3 Distinguished from Rule 10b-5. Rule 14e-3's prohibitions against trading and tipping while in possession of material nonpublic information relating to a tender offer apply regardless of any state common law duty on the part of the trader or tipper to disclose or abstain. Rather, Rule 14e-3 *creates* a federal duty to speak where one might not otherwise exist under state common law. As noted above, because the tender offeror and its agents typically have no duty to the shareholders of the target corporation, insider trading and tipping in target stock by persons associated with the tender offeror would not, absent Rule 14e-3, involve a breach of a duty to the persons with whom they trade (although, as discussed above, such trading or tipping may involve a breach of a duty to the tender offeror which might be actionable under Rule 10b-5 under the misappropriation theory).

IV. Relation of Insider Trading and Tipping to a Corporation's Duty to Disclose Material Nonpublic Information. As noted above, insider trading or tipping may, depending upon the circumstances, trigger a duty on the part of the corporation that issued the stock to which the trading or tipping relates to make public disclosures earlier than that duty might otherwise arise under the federal securities laws.

A. Mere Possession of Material Nonpublic Information Does Not Give Rise to a Disclosure Duty on the Part of a Corporation.

1. Prompt disclosure of material nonpublic information is clearly desirable for various reasons, and is generally required under the rules of the national securities exchanges and Nasdaq.[37] But, there is no general duty *under the federal securities laws* for a corporation to affirmatively disclose information merely because it is material. Rather, a corporation may remain silent as long as no duty to disclose exists.[38] Certainly, however, if a corporation does choose to speak publicly — for example, in a press release or in response to an SEC, stock exchange, or Nasdaq inquiry — it must speak fully and truthfully.[39] Similarly, if a corporation has spoken publicly with respect to a matter that is forward-looking, and such statement is still "alive" in the marketplace, the corporation may have a duty to correct or update that information if it is discovered to have been materially misleading, or even in some cases, if it becomes materially misleading due to the occurrence of subsequent events.[40]

2. In the Private Securities Litigation Reform Act of 1995, Congress adopted a safe harbor for issuers making written and oral forward-looking statements, codified in Section 27A of the Securities Act of 1933, and Section 21E of the Exchange Act. The availability of the safe harbor is subject to certain pre-conditions, such a requirement that the statements be accompanied by meaningful cautionary language. The contours (and efficacy) of the safe harbor have yet to be fleshed out by the courts. In addition, although a corporation ordinarily has no duty to correct analysts' reports, where a corporation involves itself in providing information to securities analysts, responding to their questions, and reviewing and correcting drafts of analysts' reports, the corporation may thereby assume a duty to correct such reports if they are materially incorrect.[41] Also, if the corporation is facing an SEC filing obligation — for example, a mandatory Form 8-K, a periodic Form 10-K or 10-Q, or a registration statement under the Securities Act — it must comply fully with all of the required SEC line items, as well as with the general filing requirements to disclose all other material information necessary to make the disclosures made not misleading.[42]

B. <u>Selective Disclosure Triggers Disclosure Duty under SEC Regulation FD</u>. To address concerns about the selective disclosure of material nonpublic information by issuers, the SEC adopted Regulation FD in 2000.

1. <u>Requirements of Regulation FD</u>. Regulation FD prohibits issuers (including closed-end fund investment companies) and certain persons acting on their behalf from selectively disseminating material nonpublic information to securities industry professionals, institutional investors, and certain other persons who would reasonably be expected to trade or provide trading advice on the basis of the information. Any intentional disclosure of material nonpublic information to such persons must be done in a manner that provides for simultaneous public dissemination. Any unintentional disclosure must be remedied within 24 hours or the next business day (unless the recipient has agreed to keep the information confidential). The scope of Regulation FD is limited in a number of important respects.

a. Regulation FD only applies to communications *by* an issuer's senior management (*i.e.,* those filing Section 16 reports of personal trades), its investor relations professionals, and others who regularly communicate with securities market professionals and security holders. In the case of a closed-end investment company, persons acting on its behalf include senior officials of the issuer's investment adviser. The universe of persons who "regularly" communicate with securities market professionals and security holders does not include every employee who occasionally communicates with analysts or shareholders.

b. Regulation FD applies only to an issuer's communications *with* securities market professionals, and holders of the issuer's securities under circumstances in which it is reasonably foreseeable that the security holders will trade on the basis of the information. The regulation exempts disclosures made to people owing a duty of trust or confidence to the issuer (*i.e.,* professional advisers such as attorneys, investment bankers or accountants), persons subject to a confidentiality agreement, and credit rating agencies (where the information is for credit rating purposes and the ratings are publicly available).

c. Regulation FD does not apply to issuer communications with the press, rating agencies, and ordinary-course business communications with customers and suppliers.

2. <u>Affect on the Role of Analysts</u>. The SEC made clear when adopting Regulation FD that the regulation was not intended to undermine the role of the analyst, a role the SEC characterizes as "sifting through and

extracting information that would not be significant to the ordinary investor to reach material conclusions."

a. Because the materiality of information disclosed to an analyst turns on a reasonable shareholder would view the information as such, issuers can provide analysts with nonpublic information that may be significant to a knowledgeable analyst but would not be viewed as material by the average shareholder. According to the SEC, "an issuer is not prohibited from disclosing a non-material piece of information to an analyst, even if, unbeknownst to the issuer, that piece helps the analyst complete a 'mosaic' of information that, taken together, is material." The SEC went on to say that Regulation FD is not focused on "whether an analyst, through some combination of persistence, knowledge, and insight, regards as material [any] information whose significance is not apparent to the reasonable investor."

b. Analysts may continue to engage in discussions with mid-level employees because such employees are generally not covered by Regulation FD. The SEC observed that, "if an analyst sought to ferret out information about an issuer's business by quizzing a store manager on how business was going, the store manager's response ordinarily would not trigger any Regulation FD obligations."

c. Depending on the circumstances, however, an analyst could face possible liability for aiding and abetting an issuer's violation of Regulation FD – but this would seem unlikely. The SEC release adopting Regulation FD is silent on possible aiding and abetting liability of analysts. However, then Enforcement Division Director Richard Walker gave a speech in November 2000 saying that "it would not be a common occurrence for the Division of Enforcement to charge an analyst with aiding and abetting . . . unlawful disclosure by an issuer," noting that the SEC understands that an "analyst cannot control what words a company official ultimately utters." He cautioned that analysts could face aiding and abetting liability under Regulation FD where the analyst "conspires" with the company to obtain material nonpublic information or tries to coerce the company into making selective disclosure.[43]

C. <u>Insider Trading or Tipping May Trigger an Issuer's Duty To Disclose</u>. The duty of a corporation affirmatively to disclose material nonpublic information may arise under the federal securities laws in a number of situations that might relate to insider trading and tipping with respect to the corporation's stock:

1. Where the corporation itself is trading in its own stock, such as by engaging in a stock repurchase program or a stock offering, a disclosure duty arises, at least with respect to those with whom the corporation is trading;[44]

2. Where corporate insiders are trading while in possession of material nonpublic information derived directly or indirectly from the corporation, and the corporation knows or has reason to know of such trading, such a disclosure duty may similarly arise;[45]

3. Where rumors are attributable to, or have leaked from, the corporation, and the corporation knows or has reason to know it, a disclosure duty may also arise;[46] and

4. Although no court has yet addressed the issue, where there is unusual market activity in the corporation's stock a disclosure duty may also arise.[47]

D. Insider trading or tipping may, by giving rise to a duty to disclose, deprive the corporation of meaningful latitude in the timing of disclosure (and thus may frustrate legitimate business plans), as well as result in possible "fraud-on-the-market" liability if the corporation breaches such a duty to disclose.

1. As the courts have recognized, a corporation may have a variety of legitimate business reasons to delay disclosure of material nonpublic information absent a legal duty to disclose. Certainly, this is true where such information concerns its own business operations or stock.[48] It is also true where the information involves the stock of another corporation, such as where the first corporation is contemplating a merger with, or a tender offer for the stock of, the other corporation, and premature disclosure may frustrate the transaction or, at the very least, increase its costs.[49]

2. Under the "fraud-on-the-market" theory, a corporation's breach of its duty to speak — regardless of the source of the duty — may be actionable under Rule 10b-5 by those who buy or sell its stock in the marketplace during the period of improper nondisclosure, with the theory providing a substitute for the usual Rule 10b-5 element of "reliance."[50]

V. <u>Current SEC Enforcement Focus</u>

A. <u>Insider Trading and Parallel Proceedings</u>

1. Although federal criminal prosecutors have made major headlines in the insider trading area over the last two years, the SEC also continues to be active and aggressive in pursuing such cases. To support this view, Mr. Khuzami stated, in late March 2011, that the SEC "continue[s] to vigorously enforce insider trading laws."[51] Indeed, a total of 57 actions

were brought in FY 2011 alleging insider trading violations, an 8% increase from the prior year. Defendants included individuals from hedge funds, broker-dealers, corporate boards, and even a former Nasdaq managing director. High profile cases were brought against a former board member of Goldman Sachs and involved a new product – exchange traded funds.

2. Many insider trading cases involve both criminal and SEC charges. Speaking generally about the close collaboration between the DOJ and the SEC, Deputy Director of the Division of Enforcement Lorin Reisner commented in June 2011 that, of the Commission's highest priority cases, approximately 55-65% have "some type" of parallel criminal investigation.[52]

B. <u>The Rajaratnam Criminal Conviction and SEC Judgment</u>

1. The most widely followed securities-related case of 2011 was the criminal trial of hedge fund manager Raj Rajaratnam. As we reported in 2009, the United States Attorney's Office for the Southern District of New York charged Rajaratnam with perpetrating an insider trading scheme that involved extensive and recurring insider trading ahead of various corporate announcements. Prosecutors alleged that Rajaratnam orchestrated a scheme that resulted in over $50 million in illicit profits. The case, along with a companion civil action filed by the SEC against Rajaratnam and dozens of other individuals, has reportedly led to additional inquiries involving employees at major Wall Street investment banks, expert networks, law firms and other professionals. In something of a departure from prior practice, the government made extensive use of write taps made during its investigation, the validity of which was sustained in the cases brought to trial.

2. Although most of the defendants in these civil and criminal actions settled, Rajaratnam elected to take his criminal case to trial. Following a two-month trial, Rajaratnam was convicted on May 11, 2011, on all 14 counts of conspiracy and securities fraud leveled against him. While his conviction is on appeal, Rajaratnam began serving an 11 year prison sentence in December 2011. Rajaratnam was also ordered to pay more than $53.8 million to forfeit illegal gains and $10 million in criminal fines.

3. As for the SEC, in November 2011, the Commission announced that it had obtained a record monetary penalty of $92.8 million from Rajaratnam in its own civil action. In its press release, the SEC stated that the case "marks the largest penalty ever assessed against an individual in an SEC insider trading case."[53]

VI. State Initiatives

A. Massachusetts Adopts Regulations on Expert Networks

Massachusetts is the first state in the nation to adopt new regulations to oversee the use of expert network firms by investment advisers.[54] The new regulations will be effective December 1, 2011. This practice has come under scrutiny by regulators and prosecutors investigating insider trading by looking at expert network firms that seek to link investors with industry experts for a fee, which could be a conduit for the transmission of confidential information, including the recent insider trading case involving Raj Rajaratnam, founder of hedge-fund management firm Galleon Group.

The new Massachusetts regulation would require investment advisers using expert network services to certify that consultants will not supply any confidential information as part of their service and describe all relevant confidentiality restrictions in place for the arrangement. The extent to which these regulations will apply to federally registered investment advisers is unclear. The National Securities Markets Improvement Act (NSMIA), which, among other things, preempted the states from substantively regulating federally registered investment advisers, permits states to pursue fraud actions, even with respect to federally registered investment advisers.

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[1] *Ernst & Ernst v. Hochfelder,* 425 U.S. 185, 193 n.12 (1976).

[2] *Santa Fe Industries v. Green,* 430 U.S. 462, 472 (1977).

[3] *See Herman & MacLean v. Huddleston,* 459 U.S. 375, 378 n.4 (1983).

[4] *See, e.g., In re Sterling Drug Investigation,* Exchange Act Release No. 14675 (April 18, 1978), [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 81,570, at 80,298; *see also U.S. v. Teicher,* 987 F.2d 112, 120-21 (2d Cir.) (advocating in *dictum* a possession test for insider trading liability), *cert. denied*, 114 S. Ct. 467 (1993).

[5] *See*, *SEC v. Adler*, 137 F.3d 1325, 1336-38 (11th Cir. 1998); *U.S. v. Smith*, 155 F.3d 1051, 1065-69 (9th Cir. 1998), *cert. denied*, 525 U.S. 1071 (1999).

[6] Rule 10b5-1 establishes three affirmative defenses for persons who trade a security while aware of material nonpublic information: (1) before becoming aware of the information, the person must show that a binding contract to trade the security existed, instructions were provided to another to execute the trade, or a written plan for trading existed; (2) the contract, instructions or plan for buying or selling securities either (i) expressly specified the amount, price, and date; (ii) amount, price and date were determined by a written formula or algorithm, or computer program; or (iii) did not allow the person who is aware of the information to exercise any subsequent influence over how, when, or whether to effect trades, in each case so long as the person affecting the trades was unaware of the material nonpublic information; and (3) the trades were effected pursuant to the contract, instruction or plan.

[7] *TSC Industries v. Northway, Inc.,* 426 U.S. 438, 449 (1976).

[8] *Basic, Inc. v. Levinson,* 485 U.S. 224, 238 (1988).

[9] *Selective Disclosure and Insider Trading,* Exchange Act Release 43154 (August 15, 2000).

[10] *In the Matter of Investors Management Co.,* 44 S.E.C. 633, 643 (1971).

[11] *See, e.g., Basic, Inc. v. Levinson,* 485 U.S. at 239 n.17; *SEC v. Blavin,* 557 F. Supp. 1304, 1312 (E.D. Mich. 1983), *aff'd,* 760 F.2d 607 (6th Cir. 1985).

[12] 445 U.S. 222, 235 (1980); *Accord Dirks v. United States,* 463 U.S. 646, 666 n.27 (1983).

[13] *See Carpenter v. United States,* 484 U.S. 19, 26 (1987).

[14] *See SEC v. Capital Gains Research Bureau,* 375 U.S. 180, 194 (1963).

[15] *See* Restatement (Second) of Torts § 551(2)(a) (1976).

[16] *Chiarella v. United States,* 445 U.S. at 228.

[17] 521 US 642, 654 (1997).

[18] *See United States v. O'Hagan*, 521 US at 654; *Chiarella v. United States,* 445 U.S. at 240, 245 (Burger, C.J., dissenting) (citing Keeton, *Fraud — Concealment and Nondisclosure,* 15 Texas L. Rev. 1, 25-26 (1936)).

[19] 40 S.E.C. 907 (1961) (involving a corporate insider).

[20] *See also Investors Management Co.,* (applying the disclose or abstain rule to tippees).

[21] *See Chiarella v.* United *States,* 445 U.S. at 227 n.8 (quoting Judge Learned Hand in *Gratz v. Claughton*, 187 F.2d 46, 49 (2d Cir.), *cert. denied*, 341 U.S. 920 (1951), for the principle that it would be a "sorry distinction" to say that an insider owed no fiduciary duty to one who by that very transaction becomes one of the corporation's beneficial owners). With some limited exceptions, corporations and corporate insiders generally do not owe a fiduciary duty to holders of the corporation's debt securities. *See, e.g.*, *Metropolitan Life Ins. Co. v. RJR Nabisco, Inc.*, 716 F. Supp. 1504 (S.D.N.Y. 1989). Thus, insider trading or tipping in debt securities would in most cases not be actionable under the Supreme Court's fiduciary duty analysis under Rule 10b-5. This is because the debtor-creditor relationship is viewed as contractual, not fiduciary, in nature. Nevertheless, insider trading and tipping in debt securities may be actionable under the misappropriation theory of Rule 10b-5 and under Rule 14e-3.

[22] *See, e.g., SEC v. General Dynamics Corp.,* Lit. Release No. 9021 (Feb. 27, 1980), [1979-1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,293.

[23] *See, e.g.,* W. Knepper, Liability of Corporate Officers and Directors 12 (3d ed. 1979).

[24] *See, e.g., Carpenter v. United States,* 484 U.S. at 27; *SEC v. Texas Gulf Sulphur,* 401 F.2d 833, 852 (2d Cir. 1968), *cert. denied,* 394 U.S. 976 (1969).

[25] *See, e.g., Speed v. Transamerica Corp.,* 71 F. Supp. 457, 458 (D. Del. 1947).

[26] 463 U.S. at 665 n.14; *see, e.g., SEC v. Downe,* 1993 U.S. Dist. LEXIS 753 (S.D.N.Y. 1993) (holding that a "financial public relations consultant" was a temporary insider of a corporation where he received confidential information from the corporation concerning the corporation's consideration of various restructuring options).

[27] *See, e.g., SEC v. Lund,* 570 F. Supp. 1397, 1403 (C.D. Cal. 1983) (finding that a person was a temporary insider of a corporation where he received from a corporate insider information concerning a prospective joint venture involving the corporation, and he knew that such information was confidential and had been furnished to him for a legitimate corporate purpose); *SEC v. Ingram,* [1987-1988 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,788 (C.D. Cal. 1988) (holding that a stockbroker was a temporary insider where he advised a corporation on certain aspects of a merger, he helped arrange and attended preliminary merger meetings, and there was an implied understanding that he would treat the merger information as confidential); *SEC v. Joseph J. Zilber,* Litigation Release No. 13586, 53 SEC Docket 2152 (Apr. 1, 1993) (alleging that a person was a temporary insider of a corporation where he mistakenly was told confidential information concerning the corporation's acquisition plans and he explicitly agreed to treat the information in confidence); *SEC v. Jonathan J. Sheinberg,* Litigation Release No. 13465, 52 SEC Docket 3013 (Dec. 10, 1992) (alleging that a person was a temporary insider of a corporation where he overheard his father discussing confidential information concerning the corporation and was warned by his father not to trade on or disclose the information).

[28] *Chiarella,* 445 U.S. at 230 n.12.

[29] *See* 463 U.S. at 660-62.

[30] *Dirks,* 463 U.S. at 662.

[31] *See id.* at 663; *see also SEC v. Downe,* 969 F. Supp. 149, 156 (S.D.N.Y. 1997), *aff'd, SEC v. Warde,* 151 F.3d 42 (2d Cir. 1998) (finding personal benefit in the form of a tipper being viewed as a successful investor in the eyes of his peers as well as the gratification of bestowing the "gift" of his investment expertise); *SEC v. Stevens,* Litigation Release No. 12813, 48 SEC Docket 739 (Mar. 19, 1991) (involving a corporate insider's selective disclosure to

certain analysts of material nonpublic information where such disclosure was allegedly motivated by a desire to "protect and enhance his reputation"); *In the Matter of In the Matter of Robert Bruce Lohmann,* Exchange Act Release No. 48092 (June 26, 2003) (finding personal benefit where a tipper tipped information to "friendly, if casual, office acquaintances" where the tipper "received the personal satisfaction of his generosity and the admiration of [the tippee]").

[32] *See, e.g., SEC v. Switzer,* 590 F. Supp. 756, 766 (W.D. Okla. 1984) (holding that the then University of Oklahoma (and current Dallas Cowboys) football coach was not liable for insider trading where he traded on the basis of information he had inadvertently overheard).

[33] *Cf. SEC v. Ingram,* at 98,721 n.5 (noting that intent to gain a benefit can often, absent countervailing explanation, be inferred based on a strong showing of the tipped information's materiality).

[34] *See, e.g., United States v. Chestman,* 947 F.2d 551, 570-71 (2d Cir. 1991) (*en banc*), *cert. denied,* 112 S. Ct. 1759 (1992).

[35] *See, e.g., United States v. O'Hagan,* 521 US 642 (involving breach of a duty owed by an attorney to his law firm and its client); *SEC v. Downe,* 1993 U.S. Dist. LEXIS 753 (S.D.N.Y. 1993) (involving a breach of duty owed to an investor group interested in making an offer to acquire a company by a member of that group); *SEC v. Rosenberg,* SEC Litigation Release No. 12986, 49 SEC Docket 1373 (Sept. 24, 1991) (involving a breach of duty owed by a securities analyst to his firm and its customers); *United States v. Willis,* [1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,232 (S.D.N.Y. 1990) (involving a breach of duty owed by a psychiatrist to his patient, the spouse of a corporate insider); *SEC v. Materia,* 745 F.2d 197, 202 (2d Cir. 1984) (involving a breach of duty owed by an employee of a financial printing company to that company and its clients), *cert. denied,* 471 U.S. 1053 (1985); *United States v. Newman,* 664 F.2d 12, 15 (2d Cir. 1981) (involving a breach of duty owed by an investment banker to his firm and its clients), *cert. denied,* 464 U.S. 863 (1983); *SEC v. Musella,* 578 F. Supp. 425 (S.D.N.Y. 1984) (involving a breach of duty owed by a law firm office manager to his firm and its clients).

[36] *See* 521 US at 667.

[37] *See* American Stock Exchange Company Guide §§ 401-405; New York Stock Exchange Listed Company Manual § 202.01; NASD Marketplace Rules 4310(c)(16) and 4320(e)(14) & IM-4120-1.

[38] *See, e.g., Basic, Inc. v. Levinson,* 485 U.S. at 239 n.17; *State Teachers Retirement Bd. v. Fluor Corp.,* 654 F.2d 843, 850 (2d Cir. 1981); *In re Carnation Company,* Exchange Act Release No. 22214 (July 8, 1985), [1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,801, at 87,595 n.6.

[39] *See, e.g., Basic Inc. v. Levinson,* 485 U.S. at 239 n.17; *In re Carnation Company* at 87,595.

[40] *See, e.g., Backman v. Polaroid Inc.,* 910 F.2d 10, 17 (1st Cir. 1990) (*en banc*); *Roeder v. Alpha Indus., Inc.,* 814 F.2d 22, 26-27 (1st Cir. 1987); *Ross v. A.H. Robbins Co.,* 465 F. Supp. 904, 908 (S.D.N.Y.) *rev'd. on other grounds,* 607 F.2d 545 (2d Cir. 1979), *cert. denied,* 446 U.S. 946 (1980).

[41] *See, e.g., Elkind v. Liggett & Myers, Inc.,* 635 F.2d 156, 163 (2d Cir. 1980).

[42] *See* Exchange Act Rules 10b-5 & 12b-20; Securities Act §§ 11, 12(2) & 17(a) and Rule 408.

[43] *See* Richard H. Walker, *Regulation FD – An Enforcement Perspective,* Speech before the Compliance & Legal Division of the Securities Industry Association (November 1, 2000).

[44] *See, e.g., Staffin v. Greenberg,* 672 F.2d 1196, 1204 (3d Cir. 1982); *SEC v. General Dynamics Corp.*

[45] *See Report of Investigation In re Sharon Steel Corp. as It Relates to Prompt Corporate Disclosure,* Exchange Act Release No. 18271 (Nov. 19, 1981), [1981-1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,049, at 84,615, 84,618-19. *But see Leventhal v. Katy Indus., Inc.,* No. 89-3661, slip. op. at 5 n.1 (3d Cir. Mar. 14, 1990) (unpublished decision) (rejecting, without discussion or analysis, the argument that insider trading by a corporation's directors for their own accounts imposes a disclosure duty upon the corporation itself).

[46] *See, e.g., Elkind v. Liggett & Myers, Inc.,* 635 F.2d at 163; *cf.* American Stock Exchange Company Guide §§ 401-405 (stating that, notwithstanding the general rule favoring prompt disclosure, disclosure may be delayed for a valid business purpose if *adequate security can be maintained*); New York Stock Exchange Listed Company Manual § 202.01 (same); NASD By-Laws, Schedule D, Part II, §§ 1(c)(13) & 2(e)(14) (requiring prompt disclosure of any material information that may affect stock value or influence investors' decision).

[47] *Cf.* American Stock Exchange Company Guide §§ 401(c)-(d), 402(a), (c)-(d) (requiring public announcements when there is unusual market activity in the corporation's stock); New York Stock Exchange Listed Company Manual § 202.0l (same); NASD Marketplace Rules 4310(c)(16) and 4320(e)(14) & IM-4120-1 (requiring prompt disclosure of any material information that may affect stock value or influence investors' decision).

[48] *See, e.g., Flamm v. Eberstadt,* 814 F.2d 1169, 1176-78 (7th Cir.), *cert. denied,* 484 U.S. 853 (1987) (merger negotiations); *State Teachers Retirement Bd. v. Fluor Corp.,* 654 F.2d at 850 (award of significant construction contract).

[49] *See, e.g., In re Carnation Company* at 87,595 n.6.

[50] *See, e.g., Basic Inc. v. Levinson,* 485 U.S. at 247.

[51] Remarks at SIFMA's Compliance & Legal Society Annual Seminar, March 23, 2011.

[52] "Interaction of SEC's Bounty Program, Cooperation Initiative Remains to be Seen," *BNA Securities Regulation and Law Report* (June 13, 2011).

[53] "SEC Obtains Record $92.8 Million Penalty Against Raj Rajaratnam" (Nov. 8, 2011).

[54] http://www.sec.state.ma.us/sct/sctnewregs/newreg1.htm