

DEVELOPMENTS IN INSIDER TRADING



Presented by Lois Rosenbaum

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Review: What Is Insider Trading?

Trading on basis of material, nonpublic information **in breach of duty of trust or confidence** owed directly or indirectly to issuer, shareholders, or source of information.

Includes trading by all insiders (e.g., officer, directors, attorneys, consultants, printers, doctors, family members).

SEC Rule 10b5-1

Person trades "on basis of" material nonpublic information if he trades **while aware** of such information.

Possession of information, not use, is determinative.

Legal Insider Trading

Trading in compliance with SEC regulations and internal company rules involving timing and disclosure.

Before acquiring inside information, Trader

- entered into binding contract to trade,
- instructed another to trade for his account, or
- adopted a written trading plan under Rule 10b5-1(c).

Two Theories

Classical: 10b-5 is violated when insiders trade in securities on basis of material, nonpublic information obtained by reason of their positions with corporation.

Misappropriation: 10b-5 is violated when one trades or tips in breach of duty owed to source of information.

Tipping Defined

Breaching a duty by conveying, directly or indirectly, material nonpublic information to a Tippee who has no right to be in possession of the information

Developments in Tippee Liability

SEC position:

Tippees are liable when they knew or should have known that the disclosure was in breach of an insider's duty.

Evolution of Tippee Liability

Chiarella v. US, 445 U.S. 222 (1980)

- No general duty to disclose arises from mere possession of insider information.
- Liability exists where relationship affords access to inside info and where specific relationship imposes duty of disclosure to seller (*i.e.*, duty insider owes to shareholders).

Developments in Liability

Dirks v. US, 463 U.S. 646 (1983)

- Tippee can have no derivative duty to disclose unless
 - Tipper violated a duty, and
 - Tippee knew or should have known of breach.
- Liability dependent on purpose of disclosure:
 - Insider must personally benefit directly or indirectly.
 - Elements of fiduciary duty exist when Insider gifts info to trading relative or friend.
 - Question of fact.

Developments in Liability

US v. O'Hagan, 531 U.S. 642 (1997)

- Trial court: Convicted O'Hagan for securities fraud.
- 8th Circuit Rejected misappropriation theory & overturned conviction.
- Supreme Court: Adopted misappropriation theory & reinstated conviction.

Developments in Liability

U.S. v. Newman, 773 F.3d 438 (2d Cir. 2014), reh'g denied (2d Cir. 2015), cert denied, (U.S. 10/15):

- Appeal by portfolio managers who traded on inside info received from analysts.
- Held: Tippee not liable unless gov't proves beyond reasonable doubt that Tippee *knew*:
 - Insider's disclosure violated Insider's fiduciary duties,
 - Insider personally benefitted, &
 - Tippee used info to trade or tip another for personal benefit.

U.S. v. Newman (cont'd.)

Personal benefit: Cannot be inferred from friendship without proof of “meaningfully close personal relationship that generates an exchange that is objective, consequential, & represents at least a potential gain of a pecuniary or similarly valuable nature.”

Developments in Liability

US v. Salman (792 F.3d 1087 (9th Cir. 2015))

- Affirmed jury conviction in criminal case
- Salman received tips from brother of Citigroup employee (who was also Salman's brother-in-law).
 - Evidence sufficient because Salman knew Insider was source & of Insider's close relationship & breach of fiduciary duty.
- Distinguished *Newman*, where no close personal relationship represented objective gain of pecuniary or similarly valuable nature.

Now What?

- Newman was reaction to gov't over-reaching to extend liability to remote recipients
- Supreme Court this week accepted cert in Salman case (Case No. 15-628)
- Can Salman and Newman be reconciled?