

Chapter 1

Introduction

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§ 1.1 INTRODUCTION

In this treatise, the term “insider trading” means trading by *anyone* (inside or outside of the issuer) on any type of material¹ nonpublic² information about the issuer or about the market for the security. “Tipping” or “insider tipping” is the communication by *anyone* of this type of information to another person. Thus, “insider trading” and “insider tipping” are not confined to corporate “insiders” like executives or even to those employed by the company.³ Most commentators and authorities seem to use “insider trading” in this broad sense,⁴ although the term may seem a misnomer.⁵

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- 1 For the definition of “material” under Section 10(b) of the 1934 Act, 15 U.S.C. § 78j(b) and SEC Rule 10b-5, 17 C.F.R. § 240.10b-5, see *infra* § 4.2.
 - 2 For the definition of “nonpublic” under Section 10(b) and Rule 10b-5, see *infra* § 4.3.
 - 3 On rare occasions, this treatise uses the phrase “corporate insider” to refer to a corporate employee or the equivalent of such an employee. For examples of the use of the phrase “corporate insider,” see discussion of the “classical special relationship triangle” *infra* notes 30–33 and accompanying text; see also *infra* §§ 5.2.1, 6.7.
 - 4 See Henning, *Between Chiarella and Congress: A Guide to the Private Cause of Action for Insider Trading Under the Federal Securities Laws*, 39 U. KAN. L. REV. 1, 1 (1990) (“The term ‘inside information’ is now common parlance . . . to describe situations in which previously undisclosed information is used to gain an unfair transactional or tactical advantage.”) (footnote omitted).
 - 5 See Henning, *supra* note 4, at 1 n.2 (“The term ‘insider trading’ is a misnomer because it applies to trading by persons who are not insiders of the corporate issuer.”); ABA Comm. on Fed. Regulation of Securities, Report of the Task Force on Regulation of Insider Trading, Part I: Regulation Under the Antifraud Provisions of the Securities Exchange Act of 1934, *reprinted in* 41 BUS. LAW. 223, 224 (1985) (“‘Insider trading’ is, of course, a misnomer.”).

Furthermore, this treatise is concerned with *stock market* insider trading, on both stock exchanges and the over-the-counter market,⁶ and generally not with face-to-face transactions in closely held corporations.⁷ Nevertheless, a stock market insider trade is not necessarily anonymous. First, it may be possible afterwards to identify the party on the opposite side.⁸ Second, much stock market trading is in large blocks between parties who negotiate with each other. Block trades blur the line between face-to-face and so-called “anonymous” stock market transactions.⁹

§ 1.2 OVERVIEW OF CONTENTS

This treatise analyzes the application of various laws to stock market insider trading and tipping. Among the federal laws are Securities Exchange Act (Exchange Act) Section 16, Exchange Act Section 10(b), SEC Rule 10b-5, mail/wire fraud (11 U.S.C. §§ 1341, 1343), SEC Rule 14e-3, and Securities Act Section 17(a). The state law discussed is the insider trader’s liability to the issuer and (under common law) to the party on the other side of the transaction. Other chapters address government enforcement of the insider trading/tipping prohibitions and compare the harmful and allegedly beneficial effects of stock market insider trading.

Corporate law practitioners and others concerned with securities law compliance and prevention of illegal insider trading and tipping will be especially interested in the contents of this treatise, and particularly Chapter 13 (“Compliance Programs”). Chapter 13 analyzes and provides practical suggestions about compliance programs for corporations, financial intermediaries, and professional firms.

The interrelationship of many of the chapters in this treatise may be best demonstrated with a hypothetical situation. Assume that the SEC and the Justice Department accuse an individual of illegally tipping or trading on material nonpublic information about a publicly traded stock. The treatise examines the array of laws, regulations, and legal counseling that relate to the alleged misconduct.

In this context, the following “five fingers of federal fraud” are particularly important:

1. The Section 10(b)/Rule 10b-5 classical “special relationship” theory, endorsed by the United States Supreme Court.¹⁰

6 For a brief discussion of how these markets function, see *infra* § 3.3.1.

7 Section 15.2 *infra* on the state common law of insider trading, analyzes close corporation cases because of the paucity of common law cases involving stock market transactions.

8 See *infra* § 6.7 notes 486–496 and accompanying text.

9 See *infra* § 3.3.1. For discussion of the related difficulty of drawing the line between “fortuitous” and “nonfortuitous” stock transactions, see *infra* § 8.2.2.

10 For discussion of the classical “special relationship” theory, see *infra* §§ 5.2, 5.3. *United States v. O’Hagan*, 521 U.S. 642, 651–652 (1997), called this doctrine the “‘traditional’ or ‘classical’ theory of insider trading liability.” For discussion of *O’Hagan*, see *infra* §§ 4.4.5, 4.5.2[B], 5.4 & notes 550–553, 5.4.1[B], 9.3.3.

2. The Section 10(b)/Rule 10b-5 misappropriation doctrine, also endorsed by the Supreme Court.¹¹
3. Federal mail and wire fraud, which the Supreme Court has unanimously held applies to stock market insider trading and tipping and which the Congress has since further broadened.¹²
4. SEC Rule 14e-3, regulating insider trading and tipping in the context of tender offers.¹³
5. Securities Act Section 17(a).¹⁴

One of the most potent weapons is Exchange Act Section 10(b)/SEC Rule 10b-5. Initially, one must determine whether the subject party's conduct met the many requirements of a Section 10(b)/Rule 10b-5 violation.¹⁵ For example, was the information material¹⁶ and nonpublic?¹⁷ Did the individual have the requisite scienter?¹⁸ Did the accused breach a duty to disclose under the two principal bases of Section 10(b)/Rule 10b-5 liability: the classical "special relationship" theory¹⁹ and the misappropriation doctrine?²⁰ As will be addressed in this treatise, the Supreme Court has endorsed both of these approaches.²¹

The courts use different terms to describe what this treatise calls the classical "special relationship" theory, or, more simply, the "special relationship" theory. In *Dirks v. SEC*,²² the Supreme Court referred to a "special relationship" between the insider

11 See *United States v. O'Hagan*, 521 U.S. 642, 649–666 (1997). For discussion of the misappropriation theory, see *infra* §§ 4.5.2, 5.4. For discussion of *O'Hagan*, see *infra* §§ 4.4.5, 4.5.2[B], 5.4 & notes 550–553, 5:4.1[B], 9.3.3.

12 For discussion of the federal mail and wire fraud statutes, see *infra* Chapter 11.

13 For discussion of SEC Rule 14e-3, see *infra* Chapter 9.

14 For discussion of Section 17(a) of the Securities Act of 1933, see *infra* Chapter 10.

For a brief summary of when stock market insider trading and tipping violates federal securities law and some of the remedies and sanctions, see Wang, *Stock Market Insider Trading: Victims, Violators and Remedies—Including an Analogy to Fraud in the Sale of a Used Car With a Generic Defect*, 45 Vill. L. Rev. 27, 45–63, 66–67 (2000). For another concise description of the federal law regulating insider trading (including Section 16), see ABA Comm. on Corporate Laws, Section of Bus. Law, *Corporate Director's Guidebook* 98–101 (5th ed. 2007); *CORPORATE DIRECTOR'S GUIDEBOOK, FIFTH EDITION*, 62 BUS. LAW. 1479, 1542–1544 (2007). For a brief description of SEC Rule 10b-5's application to insider trading, see Haynes, *Insider Trading Under Rule 10b-5*, 29 A.L.I.-A.B.A. BUS. L. COURSE MATERIALS J. No. 5, at 5 (Oct. 2005). For a "gallery" on the development of the law of insider trading, see "Fair to All People: The SEC and the Regulation of Insider Trading," available at www.sechistorical.org/museum/galleries/it. For the transcript of a May 22, 2007 "fireside chat" on the regulation of insider trading, see http://c0403731.cdn.cloudfiles.rackspacecloud.com/collection/programs/Transcript_2007_0522_Insider.pdf.

15 For discussion of several of these requirements, see *infra* §§ 4.1–4.6.

16 For the definition of "material" under Section 10(b) and Rule 10b-5, see *infra* § 4.2.

17 For the definition of "nonpublic" under Section 10(b) and Rule 10b-5, see *infra* § 4.3.

18 For discussion of scienter under Section 10(b) and Rule 10b-5, see *infra* § 4.4.

19 For discussion of the classical "special relationship theory," see *infra* §§ 5.2, 5.3.

20 For discussion of the misappropriation doctrine, *infra* § 5.4.

21 See sources cited *supra* notes 10–11.

22 463 U.S. 646 (1983).

trader and the party on the other side of the trade.²³ In his dissent in *Chiarella v. United States*,²⁴ Justice Blackmun said that the majority required a “special relationship.”²⁵ The U.S. Court of Appeals for the Second Circuit has employed the term “traditional theory” for the same concept.²⁶ Similarly, other federal appellate courts have used the phrase “classical theory.”²⁷ In *United States v. O’Hagan*,²⁸ the Supreme Court referred to the “‘traditional’ or ‘classical theory’ of insider trading liability.”²⁹ All these terms are synonymous.

The classical “special relationship” is a triangle:

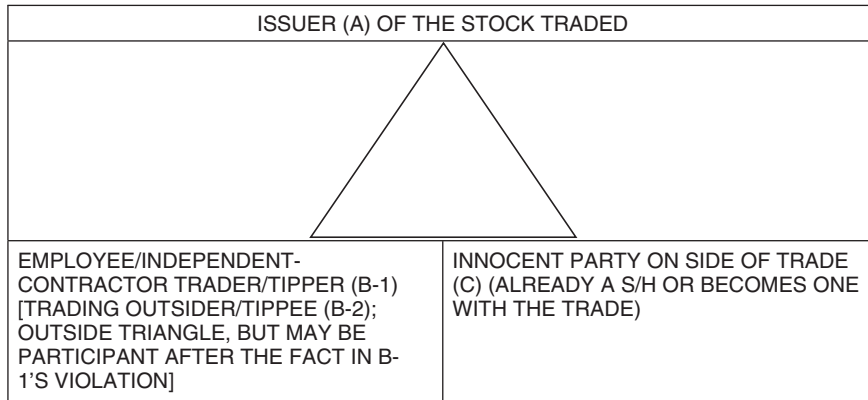


Figure 1.1

At the apex of the triangle is the issuer (A) of the stock traded. At the left base of the triangle is the “corporate insider” trader/tipper (B-1). At the right base of the triangle is the innocent party (C) on the other side of the insider trade. The “corporate insider” trader/tipper (B-1) is in the triangle usually because of his direct or *indirect* employment by the issuer.³⁰ The innocent party (C) on the other side of the trade is in the

23 See *id.* at 656 n.15 (stating that “we do not believe that the mere receipt of information from an insider creates such a special relationship between the tippee and the corporation’s shareholders”).

24 455 U.S. 222 (1980).

25 *Id.* at 246 (“Such confinement in this case is now achieved by imposition of a requirement of a ‘special relationship’ akin to a fiduciary duty before the statute gives rise to a duty to disclose or to abstain from trading upon material, nonpublic information.”) (Blackmun, J., dissenting) (footnote omitted). See *id.* at 246 n.1 (“The Court fails to specify whether the obligations of a special relationship.”) (Blackmun, J., dissenting).

26 See *United States v. Chestman*, 947 F.2d 551, 564–566 (2d Cir. 1991) (en banc).

27 See, e.g., *SEC v. Maio*, 51 F. 3d 623, 631 (7th Cir. 1995); *SEC v. Cherif*, 933 F. 2d 403, 408–409 (7th Cir. 1991); *SEC v. Clark*, 915 F. 2d 439, 443 (9th Cir. 1990).

28 521 U.S. 642 (1997).

29 *Id.* at 641. See *id.* at 652 (employing the term “classical theory”).

30 For discussion of why employees (B-1) are in the classical special relationship triangle, see *infra* §§ 5.2.1, 5.2.2, 5.2.3[A]. Independent contractors of the issuer are in the triangle in the same position as employees (B-1). See *infra* § 5.2.3[B]. The issuing corporation itself should also be in the triangle in the same position as an employee (B-1). See *infra* § 5.2.3[C].

triangle because of his ownership of at least one share of stock of the issuer (A). This shareholder (C) has invested in the company or “steps into the shoes” of an original investor.

Because of their *mutual* relationship to the issuer, the “corporate insider” trader/tipper and the party on the other side of the trade have a special relationship. The special relationship creates a duty to disclose.³¹

Under the classical special relationship theory, a “corporate insider”/tipper (B-1) breaches his fiduciary duty by tipping only if he receives a *personal benefit* from the disclosure.³² The outsider/tippee may be liable if the “corporate insider”/tipper breaches a duty by tipping and if the tippee (B-2) knows or should know of that breach. In that instance, the tippee (B-2) participates after the fact in the “corporate insider”/tipper’s (B-1) breach of a duty to disclose to the party (C) on the other side of the *tippee’s* trade.³³

Many stock market insider traders or tippers may avoid liability under the classical special relationship theory. One example is someone who is neither an employee of the issuer, the equivalent of an employee, nor a direct or indirect tippee of such an employee or employee-equivalent.³⁴

To fill this gap, the Supreme Court has endorsed the misappropriation doctrine.³⁵ This theory bases Section 10(b) and Rule 10b-5 liability on a breach of duty to the information source.³⁶

As this treatise addresses, one key issue is whether liability is premised on the defendant’s merely possessing the inside information or the defendant’s actual “use” of the information in deciding to trade. Responding to this issue, the SEC in 2000 adopted Rule 10b5-1. With certain exceptions, Rule 10b5-1 posits that Section 10(b) insider trading liability generally arises when someone trades while “aware” of material nonpublic information.³⁷

For discussion of whether a “temporary insider” may be in the triangle in the same position as an employee (B-1), even if the “temporary insider” is neither an employee nor an independent contractor of the issuer, see *infra* § 5.2.3[D]. For discussion of whether a controlling or large shareholder may be in the triangle in the same position as an employee (B-1), see *infra* § 5.2.3[E]. For discussion of other *possible* classical “special relationships” outside the classical special relationship triangle, see *infra* §§ 5.2.3[F], 5.2.3[G], 5.2.3[H].

31 See *Chiarella v. United States*, 445 U.S. 222 (1980). For additional discussion of the classical “special relationship” triangle, see *infra* § 5.2.1.

32 See *Dirks v. SEC*, 463 U.S. 646 (1983). For discussion of tipper liability under the classical special relationship theory, see *infra* § 5.2.8.

33 For discussion of tippee liability under the classical special relationship theory, see *infra* § 5.3.

34 For discussion of various other possible “special relationships” see *infra* §§ 5.2.3[F]-5.2.3[H].

35 See *United States v. O’Hagan*, 521 U.S. at 649–666 (1997). For discussion of *O’Hagan*, see *infra* §§ 4.4.5, 4.5.2[B], 5.4 & notes 550–553, 5.4.1[B], 9.3.3.

36 521 U.S. at 647 (recognizing the “breach of a fiduciary duty to the source of the information”); 521 U.S. at 652 (same).

37 For the full text of Rule 10b5-1 and the accompanying release, see SEC Rel. Nos. 33-7881, 34-43154, IC-24599, File No. S7-31-99, 73 S.E.C. Docket 3 (Aug. 15, 2000). For discussion

A summary of Rule 10b-5's application to stock market insider trading is in SEC Rule 10b5-1(a):

General. The “manipulative and deceptive devices” prohibited by Section 10(b) of the Act . . . and [Rule] 10b-5 thereunder include, among other things, the purchase or sale of a security of any issuer, on the basis of material nonpublic information about that security or issuer, in breach of a duty of trust or confidence that is owed directly, indirectly, or derivatively, to the issuer of that security or the shareholders of that issuer, or to any other person who is the source of the material nonpublic information.

The release accompanying the proposed rule stated: “This language incorporates all theories of insider trading liability under the case law—classical insider trading, temporary insider theory, tippee liability, and trading by someone who misappropriated the inside information.”³⁸

In criminal prosecutions of insider trading or tipping, the federal mail and wire fraud statutes are another major weapon. In *Carpenter v. United States*,³⁹ a unanimous Supreme Court held that certain insider trading and tipping defendants violated the federal mail fraud and wire fraud statutes. After *Carpenter*, Congress in 1988 amended the United States Code chapter containing both the mail and wire fraud statutes to provide that “schemes to defraud” encompass schemes “to deprive another of the intangible right of honest services.”⁴⁰ This amendment enlarges the already broad sweep of mail/wire fraud and thereby enhances its importance in the criminal prosecution of insider trading and tipping.

In addition to Section 10(b)/Rule 10b-5 and mail/wire fraud, other federal statutes or SEC rules may apply. SEC Rule 14e-3 covers insider trading and tipping in the tender offer context.⁴¹ Section 17(a) of the Securities Act of 1933 prohibits fraud in the offer or sale of securities.⁴² At least in the SEC enforcement setting, the statute encompasses

of Rule 10b5-1, see, e.g., *infra* §§ 4.4.5, 4.5.3, 5.2.3[C] & notes 146–151, 5.2.3[G] note 325, 13.2.3 & note 48, 13.2.4, 13.3.3, 13.5.2[C][3], 13.6.2[B] & notes 410–415.

For the text of the rule as originally proposed and its accompanying release, see SEC Rel. Nos. 33-7787, 34-42259, IC-24209, File No. S7-31-99, 71 S.E.C. Docket 732 (Dec. 20, 1999), [1999–2000 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,228, at 82,846 [release hereinafter cited as *Proposing Release*], available at <http://www.sec.gov/rules/proposed/34-42259.htm>.

For the SEC staff's answers to some frequently asked questions about Rule 10b5-1, see <http://www.sec.gov/divisions/corpfin/guidance/exchangeactrules-interps.htm>; www.sec.gov/interps/telephone/phonesupplement4.htm.

38 See *Proposing Release*, *supra* note 37, Sec. III.A.2 n.86 (citing *United States v. O'Hagan*, 521 U.S. 642 (1997), *Dirks v. SEC*, 463 U.S. 646 (1983); *Chiarella v. United States*, 445 U.S. 222 (1980)).

39 484 U.S. 19, 25–28 (1987). *Carpenter* is discussed in several sections of Chapter 11, including §§ 11.3.1 and 11.3.2[A].

40 18 U.S.C. § 1346, as amended by Pub. L. No. 100-690 (1988). As amended, that statute provides: “For the purposes of this chapter, the term ‘scheme or artifice to defraud’ includes a scheme or artifice to deprive another of the intangible right of honest services.”

41 See *infra* Chapter 9.

42 See *infra* §§ 10.1–10.4.

negligent conduct.⁴³ This latter statutory provision is broad enough to cover some *selling* on insider information or tipping of *bearish* nonpublic news.⁴⁴

The treatise also examines the civil and criminal remedies as well as penalties the government might seek to impose on the defendant.⁴⁵

Irrespective of the initiation of government actions, private civil plaintiffs may seek relief against an alleged insider trader or tipper. The treatise describes elements of private civil liability, including the remedies obtainable.⁴⁶

Plaintiffs may pursue express and/or implied private rights of action under various federal statutes and rules. For example, Section 20A of the Securities Exchange Act creates an *express* private action for contemporaneous traders suing someone whose insider trade or tip violates the Exchange Act or its rules, including Section 10(b)/Rule 10b-5 and Rule 14e-3.⁴⁷

The Supreme Court has recognized an implied private cause of action under Section 10(b) and Rule 10b-5⁴⁸ but has not ruled whether such causes of action exist under mail/wire fraud, Securities Act Section 17(a), or SEC Rule 14e-3.

Nevertheless, the lower federal courts uniformly have held that a private right of action does not exist under the mail fraud or wire fraud statutes.⁴⁹ Likewise, lower federal courts have refused to imply such an action under Securities Act Section 17(a).⁵⁰ Although some case law supports the existence of an implied private action under SEC Rule 14e-3,⁵¹ this issue remains unresolved.⁵² Section 20A, however, creates an express private action against Rule 14e-3 violators.⁵³

This treatise also examines Exchange Act Section 16(b), which expressly allows the recovery by or on behalf of the subject corporation of “short-swing” profits of statutorily defined insiders who trade the company’s “equity securities.” Section 16(b)’s cause of action may be invoked only in specified circumstances.⁵⁴

43 See *Aaron v. SEC*, 446 U.S. 680, 696–97 (1980) (holding that SEC need not prove scienter in actions brought for violation of Section 17(a)(2) or 17(a)(3)). For discussion of the standard of culpability under Section 17(a), see *infra* § 10.4.

44 See *infra* §§ 10.1, 10.3, 10.4. For general discussion of Section 17(a)’s application to stock market insider trading and tipping, see *infra* Chapter 10.

45 See *infra* Chapter 7.

46 See *infra* §§ 4.7–4.9.

47 For discussion of Section 20A’s limitation to violations of the Exchange Act and its rules, see *infra* § 10.7.

48 See *Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson*, 501 U.S. 350, 358 (1991) (stating that “this Court repeatedly has recognized the validity of such claims”); *Herman & MacLean v. Huddleston*, 459 U.S. 375, 380 (1983) (“The existence of this implied remedy is simply beyond peradventure.”); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 196 (1976) (observing that “the existence of a private cause of action . . . is now well established”).

49 See *infra* § 11.1 note 17 and accompanying text.

50 See *infra* § 10.5.

51 See *infra* § 9.4.2 note 145.

52 See *infra* § 9.4.2.

53 See *infra* §§ 6.2, 9.4.2.

54 For discussion of Section 16(b), see *infra* Chapter 14.

In addition to federal law, state law may apply. This treatise discusses both (1) the common law liability of an insider trader to the party on the other side of the transaction and (2) the liability of an insider trader to the corporation that issued the stock traded.⁵⁵

One chapter of this treatise also describes the approach to insider trading and tipping adopted by the American Law Institute's (ALI) Federal Securities Code.⁵⁶ Congress has not adopted the ALI's Code.⁵⁷ Nonetheless, the ALI Code provides an interesting comparative approach.

Two chapters examine the justification for the regulation of stock market insider trading from a policy perspective. These chapters may be of special interest to academics in law and other disciplines. One of these chapters analyzes the alleged benefits and detriments to society of stock market insider trading.⁵⁸ The other chapter discusses the harm to individual investors from insider trading in an impersonal stock market.⁵⁹ Each stock market insider trade has specific victims, although, in practice, they are unidentifiable. The outstanding number of shares of a company generally remains constant between the insider trade and public dissemination of the information on which the insider acted. With an insider *purchase* of an existing issue of securities, the insider has more of that issue at dissemination; someone else must have less. That person is worse off because of the insider trade. With an insider *sale* of an existing issue of securities, the insider has less of that issue at dissemination; someone else must have more. That person is worse off because of the insider trade. This treatise calls this phenomenon "the law of conservation of securities."⁶⁰

Thus, this treatise's primary focus is on the "five fingers of federal fraud,"⁶¹ the Section 10(b)/Rule 10b-5 classical special relationship theory, the Section 10(b)/Rule 10b-5 misappropriation theory, federal mail and wire fraud, SEC Rule 14e-3, and Securities Act Section 17(a). These provisions are the principal weapons against stock market insider trading and tipping.

55 See *infra* Chapter 15.

56 See *infra* Chapter 8.

57 See Albert, *Company Registration in its Historical Context: Evolution Not Revolution*, 9 U. MIAMI BUS. L. REV. 67, 79–80 (2001).

58 See *infra* Chapter 2.

59 See *infra* Chapter 3.

60 See *infra* § 3.3.5.

61 See *supra* notes 10–14 and accompanying text.