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The Evolving Insider Trading Debate

Insider trading, commonly defined as trading in securities while having knowledge of significant undisclosed information about the company, remains an important target in private securities litigation and of the Securities & Exchange Commission ("SEC"). Understanding the evolving legal requirements is critical for corporate insiders and their counsel, because insider-trading violations can result in a disgorgement of profits and a treble penalty. Furthermore, the stigma of an insider trading violation can effectively bar an individual from serving as an officer or director of a public company, even where the SEC has not sought such a bar in an enforcement proceeding. Exploring all the motivating factors for relevant purchases or sales has become increasingly important in counseling clients prior to litigation and in defending pending claims.

While insider trading charges are usually brought under Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), and Rule 10b-5 thereunder, 17 C.F.R. § 240.10b-5, the courts have not been uniform in interpreting certain key statutory language, such as whether a causation element is required. Two recent cases, *SEC v. Adler*, 137 F.3d 1325 (11th Cir. 1998), and *U.S. v. Smith*, 155 F.3d 1051 (9th Cir. 1998), *cert. denied*, 142 L.Ed. 2d 664 (1999), have refined the legal landscape by emphasizing that "use" of the material information is an essential element of an insider trading violation. Under these recent cases, the SEC must show that the material nonpublic information was "used," *i.e.*, caused the alleged wrongdoer to trade. The *Adler* and *Smith* decisions rejected the SEC's position that an insider's mere possession of important nonpublic information taints a trade in



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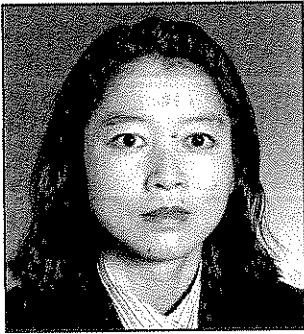
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the company's stock. The *Adler* and *Smith* cases shift the factual battleground to whether the inside information was used to buy or sell and what other pre-existing motives may have caused the trade.

Serious civil and criminal penalties can be imposed against alleged illegal traders. Under the Insider Trading Sanctions Act of 1984, 15 U.S.C. § 78u-1, the SEC may seek a civil penalty of up to three times the profit gained (or loss avoided) by parties who unlawfully trade in securities or "tip" others to trade. The SEC has broad authority to investigate possible violations of the federal securities laws and can use its subpoena power to compel witnesses to testify or produce written records or other evidence. In practice, the SEC normally pursues alleged insider traders with injunctive actions that also seek disgorgement of illegal profits and civil penalties. The SEC can also refer a matter to the Department of Justice or the local U.S. Attorney to determine whether criminal proceedings are warranted.



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The Origins of the Use vs. Possession Debate

Over the years, the courts have set no uniform standard concerning whether the confidential material information must have some causal relationship to the insider's trade.

Senior personnel within a public company are necessarily exposed to nonpublic information in the course of their work, so some courts have suggested that mere knowledge of such information while trading is not enough to show misconduct. Insiders may be motivated to trade for reasons that are separate and unrelated to nonpublic information (e.g., as part of pre-planned, periodic programs to exercise and sell stock options) that may help remove any taint from the trading in question.

Since the 1960's, the SEC has often argued that an insider's mere possession of material nonpublic information prior to trading in the company's stock was enough to make the trades illegal. See *In re Cady, Roberts & Co.*, 40 S.E.C. 907 (1961), and *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968), cert. denied, 394 U.S. 976 (1969). This position was expressly adopted by the SEC in *In re Sterling Drug Inc.*, [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 81,570 (1978), where the SEC declared that "Rule 10b-5 does not require a showing that an insider sold his securities for the purpose of taking advantage of material non-public information... If an insider sells his securities while in possession of material adverse non-public information, such an insider is taking advantage of his position to the detriment of the public." *Id.* at 80,298.

Since *Cady* and *Texas Gulf Sulphur*, some U.S. Supreme Court decisions have supported a "use" theory by finding that mere possession of inside information while trading is not enough for liability. In *Chiarella v. United*

States, 445 U.S. 222 (1980), Chiarella was employed by a printing company that prepared solicitation materials for bidders in tender offers. After deducing codes used to disguise the target company's name, Chiarella profited from the purchase of the target company's stock. The Court repeated the familiar principle that, under Section 10(b), a corporate insider has a duty to disclose material nonpublic information or abstain from trading on the information. *Id.* at 226-228. However, Chiarella's conviction was reversed because he had no fiduciary duty to sellers of the target company's stock. *Id.* at 232-233. The Court thus rejected a liability theory based solely on a person's informational advantage. In fact, the Court stated that "a duty to disclose under Section 10(b) does not arise from the mere possession of nonpublic market information." *Id.* at 235. The Court also stated that the "federal courts have found violations of § 10(b) where corporation insiders used undisclosed information for their own benefit." *Id.* at 229 (emphasis added).

Other Supreme Court cases indicate, at least indirectly, that the use, not the possession, of the confidential information formed the crux of liability. *United States v. O'Hagan*, 521 U.S. 642, S.Ct. 2199 (1997), involved an attorney who misappropriated information relating to an imminent tender offer by Grand Metropolitan to acquire Pillsbury Company. Grand Met had retained O'Hagan's law firm as counsel. In breach of his fiduciary duty to his law firm and its client, O'Hagan purchased call options for Pillsbury stock, which rose dramatically after Grand Met publicly announced its tender offer. The Court ruled that insider trading liability arises "when a corporate insider trades in the securities of his corporation on the basis of material, nonpublic information. Trading on such information qualifies as a 'deceptive device' under § 10(b)." 117 S.Ct. at 2207 (emphasis added). In *O'Hagan*, the Court ruled that "the fiduciary's fraud is consummated, not when the fiduciary gains the confidential information, but when, without disclosure to his principal, he uses the information to purchase or sell securities..." *O'Hagan*, 117 S.Ct. at 2209. In finding against the defendant attorney the Court confirms that persons other than literal insiders within a company may still be liable for insider trading where the duty and use elements are present.

Other courts have supported a "possession" approach to liability. In *United States v. Teicher*, 987 F.2d 112 (2d Cir. 1993), cert. denied, 510 U.S. 976 (1993), the Second Circuit affirmed the convictions of tippees who traded while in possession of information that was misappropriated by their tipper. Although the Court affirmed the conviction based on harmless error, the Court supported the "knowing possession" standard advocated by the SEC in dictum. Under the SEC's approach, an insider who trades in securities while having material nonpublic information is liable for securities fraud, whether or not the inside information caused or influenced the trade. The court declined to adopt the alternative "use" approach, because requiring a "causal connection between the information and the trade could frustrate attempts to distinguish between legitimate trades and those conducted in connection with inside information". *Id.* at 121.

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The *Adler* and *Smith* Cases Refine the Issue

The Ninth and Eleventh Circuits have rejected the SEC's position that mere possession of material inside information is sufficient to impose liability. In *SEC v. Adler*, the SEC brought a civil action against several current and former executives of Comptronix Corporation for insider trading violations. Certain executives' sales of stock were made only days after a Board of Directors meeting at which negative sales information was discussed. Some defendants contended that their stock sales were made as part of a pre-existing plan and presented evidence of pre-Board meeting discussions with a broker about selling the stock and of a "lock up" restriction that had prevented selling earlier. Defendants secured judgments in their favor. On appeal, the SEC argued that the possession of inside information was sufficient for liability and that no causal relationship between the information and the trade need be proven. *Id.* at 1332. The Eleventh Circuit rejected the SEC's position and adopted a rule that actual "use" of the alleged inside information was necessary, but reversed the judgments in favor of defendants and returned the matter to the trial court for further proceedings. *Id.* at 1343-44. Reviewing the language of Section 10(b) and Rule 10b-5, the Court concluded that the statutory emphasis on "fraud and deception" was more consistent with a "use" standard. *Id.* at 1337-38. *Adler* rejected the SEC's possession test, in part for fear that it would cast too wide a net and would go beyond situations involving actual fraud. *Id.* However, to address the concern that an unduly difficult burden of proof would otherwise be imposed on the SEC, the Court held that a "strong inference of use" arises from proof that an insider traded while in possession of insider information. *Id.* The insider can attempt to rebut the inference with evidence that there was no causal connection between the information and the trade — *i.e.*, that the information was not used. *Id.*

The *Adler* court also noted the possibility that the SEC could promulgate a rule adopting the knowing possession standard, as it had done in the tender offer context. *Id.* at 1337, n. 33. While this comment appears to be dictum, it may give rise to a new controversy over the SEC's authority to overturn precedent through its rulemaking authority.

In *United States v. Smith*, 155 F.3d 1051 (9th Cir. 1998), a criminal action for insider trading was brought against Richard Smith, the Vice President of PDA Engineering. Smith sold all his company stock and shorted 35,000 additional shares after discovering a \$1.5 million budget mistake that could cause a stock price decline. The executive's parents also sold and/or shorted a total of 12,000 shares. Smith telephoned the Los Angeles office of PDA and left a voicemail message for a co-employee that revealed his discovery of the budget error and his sale of all his shares because he knew the announcement would cause a price decline. *Id.* at 1053. The damaging telephone message was excluded from evidence at the trial, but Smith was nevertheless found guilty on all eleven counts of insider trading. *Id.* at 1054.

On appeal, the federal appellate court affirmed the conviction, but held that the government must prove that "the suspected insider trader actually used material nonpublic information in consummating his transaction." *Id.* at 1069.

Under *Smith*, the material nonpublic information must be a "significant factor" in the trading decision. *Id.* at 1070, n. 28. If the insider possesses, but does not use such information, the insider arguably is not trading to the disadvantage of other parties. *Id.* at 1068. For example, to the extent that the insider was simply implementing a previously formed financial strategy, the insider was not "using" the information to the detriment of other shareholders. While the SEC has argued that this use standard would pose difficulties of proof, the *Smith* court indicated that in criminal actions, the government could use circumstantial evidence to prove causation, as it normally does in insider trading actions.

The "use vs. possession" controversy remains an evolving area of insider trading law, and the United States Supreme Court has yet to squarely address this distinction. While the SEC has consistently refused to accept the "use" argument as valid in practice, it has sometimes declined to bring cases where a strong use argument is present.

Going forward, the *Adler* and *Smith* cases will be helpful in defending insider trading claims by the SEC or civil plaintiffs, but they should not be viewed as a solid shield against liability. Insider trading cases will continue to be predominantly fact-driven. In the meantime, corporate insiders should consider a regular periodic sale-of-shares program within "window" periods (*i.e.*, the periods during the year, generally after quarterly financial announcements, in which corporate insiders are allowed to trade their companies' shares). This may help undermine any subsequent assertion of improper "use" of confidential information. Courts may find, however, that such pre-existing plans should not immunize particular sales while in possession of significant negative information about the company's near term prospects. Even trades caused by a unique personal need for liquidity may be suspect in light of the insider's other financial options, such as borrowing funds or liquidating other assets. In addition, class plaintiffs' counsel usually weigh heavily any sales by insiders in deciding which companies to sue and which individual defendants to name. Any trades that fall within an alleged class period can trigger an individual's inclusion in a class-action complaint (and the resulting expense and publicity), regardless of the personal justification.

In practice, *Adler* and *Smith* should increase the chances of successfully defending against insider trading claims. Clients should realize, however, that the prospect of having to explain their trades to the SEC or a court should still dictate a conservative approach: The only riskless strategy remains to abstain from trading until the arguably material information is disclosed to the investing public.

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