On Securities

Charles R. Rice

The SEC has complained to the *Wall Street Journal* that a recent local decision is a "blow to the government effort" to enforce the insider trading laws in Silicon Valley. See *SEC v. Truong*, 2000 U.S. Dist. LEXIS 6505 (N.D. Cal. April 12, 2000). Unfortunately, that analysis will become a self-fulfilling prophecy if the SEC does not learn the right lessons from the Truong decision. (In the interests of full disclosure, I should mention that my colleague Jahan Raissi was one of the successful defense lawyers.)

SUSPICIOUS TRADING

The SEC had sued Hanh Truong, a software manager at Molecular Dynamics, Inc. ("MDI"), two of his brothers, and several friends for allegedly using material, nonpublic information to sell (and short-sell) MDI stock just before a negative quarterly announcement. According to the SEC, the volume, timing, and success of defendants' stock trading indicated that they had used inside information. Even though Truong was not a senior manager and all of the senior MDI managers who had known the bad news denied telling him, the SEC claimed that Truong had had access to inside information because of MDI's open cubicle environment.

Judge Spencer Williams granted partial summary judgment to defendants, finding no evidence that they had possessed, much less used, any particular inside information before certain trades. Judge Williams relied on the Ninth Circuit's holding in *U.S. v. Smith*, 155 F. 3d 1051 (9th Cir. 1998), that the government must prove that the defendant "*used* the inside information in formulating or consummating" the stock trades. *Id*. at 1070 n. 28 (emphasis added). See Friese and Chan, "The Evolving Insider Trading Debate," *ABTL Report* (March 1999).

Judge Williams rejected the central premise of the SEC's case: that suspicious trading, by itself, could warrant an inference that the defendant must have illegally used inside information. Truong at *31. Allowing a jury to draw such an inference from suspicious trading alone, the court reasoned, "would relieve the SEC of its burden to identify the [inside] information, prove its materiality and prove possession and use" by the defendants. Id. Nor could the SEC prove possession and use by showing "access" to inside information from "the mere open-cubicle environment" of MDI. *Id*. at *35. Otherwise, the court reasoned, "virtually everyone in Silicon Valley … who has merely normal professional relationships with senior management must be considered to have access to confidential information for insider trading purposes." *Id*.

TRADING YOUR OWN COMPANY

It may seem fishy to sell all of your own company's stock, especially just before a drop in the market. Unlike Pete Rose betting against his own baseball team, however, an employee must be permitted, just like any other shareholder, to recognize that "what goes up may come down." The securities laws allow employees to bet for and against their own companies – as long as their bets are not based on material nonpublic information.

Employees do not necessarily have an unfair advantage when trading their own stock. A mid-level employee is not really any better informed about what will affect the stock price than analysts and other traders. To the contrary, market professionals usually have greater access to material financial information than all but the most senior management. Employees may have a "feel" for what is happening, but that "feel" may not be very helpful in guessing the market's next move. It should not make an employee's trading illegal.

The SEC wants to be allowed to prove that an employee was using illegal insider information by simply showing that the trading was suspicious, in hindsight, because of its volume, timing, and success. Such a rule, however, would shift the burden to the employee to defend his trading without any proof that he had any particular information that was both material and nonpublic.

PROSECUTORIAL DISCRETION

The SEC has publicly defended its reliance on circumstantial evidence in the *Truong* case, but it should be reconsidering why the case was brought in the first place. The agency invested five years of effort on this matter, but never uncovered any evidence that defendants had any specific inside information. Unfortunately, institutional momentum apparently resulted in charges being brought even though there was no “smoking gun.”

Despite the SEC’s public comments, this case will not necessarily be a “blow” to its insider trading enforcement. The SEC must remember that no one wins when it accuses someone of fraud without enough evidence. Both the agency and the “vindicated” defendants lose time, money, and public stature. The agency will better serve the interests of justice and the investing public by electing not to prosecute marginal cases. Such discretion would strengthen, not weaken, the SEC’s enforcement efforts as a whole.