INSIDER TRADING

Insider trading is the buying or selling of securities based upon access to confidential or proprietary information, which is not available to the general public. An insider is one who is restricted from some kind of trading in a company’s stock because he/she has access to privileged information. Insider trading has been a controversial issue in this country and is closely watched by the Securities and Exchange Commission. Section 16 of the 1934 Act prevents short-term trading and other transactions in a corporation’s securities by corporate insiders.

The Securities Act of 1933 and the Securities Exchange Act of 1934 was passed by Franklin D. Roosevelt, during the New Deal, in response to the crash in the 1930’s. In that period, the DJIA dropped by 89%. The Crash was caused by five factors: 1) Pre-crash speculation fueled by unrestrained credit, 2) Manipulative practices by brokers creating appearances of trading activity, 3) False or misleading statements by issuers, 4) Lack of periodic disclosure by companies whose stock is publicly traded, and 5) rampant insider trading. The Securities Act of 1933 governs the public distribution of securities for the first time, while the 1934 Act governs subsequent trading in those securities among private investors on the various securities exchanges. The 1934 Act also requires periodic disclosures of financial information by companies who have publicly traded securities (Roszkowski 856).

The 1934 Securities Act was actually the Act that created the Securities and Exchange Commission. The SEC has five members, and no more than three are allowed to be from the same political party (Tewles 351). The SEC members are appointed by the President of the U.S. and confirmed by the Senate. They each serve five year
staggered terms. The SEC has rule making power, “quasi-legislative,” the power to
investigate violations, “quasi-executive,” and the power to adjudicate (impose penalties),
“quasi-judicial.”

Section 16 of the 1934 Act contains insider-trading regulations. The persons
covered are corporate officers, corporate directors, and any person with greater than 10%
stake in a company. These people must file a notice with the SEC within 10 days after
qualifying as an insider. Also, they’re required to report transactions in a company’s
stock within 10 days after the end of the month in which it occurred. For example, if an
insider purchases shares of his/her company on April 20, then he/she is required to report
this transaction to the SEC by May 10. If an insider fails to abide by Section 16(a), then
the SEC may impose administrative and criminal sanctions (Roszkowski 875).

Section 16(b) restricts short-term trading in the issuer’s stock by persons subject
to the 16(a) filing requirements. It allows the recovery by the corporation or issuer (or
the shareholder suing on behalf of the issuer) of any profit realized by the insider on the
sale and purchase or purchase and sale of the company’s stock within any six month
period. “Profit” is computed by comparing the highest sales price against the lowest
purchase price within any six-month period. For example, if an insider buys a stock at
$10 per share, and then sells it at $20 within six months, that $10 difference is
recoverable by the corporation. Section 16 imposes strict liability, which means that
short-swing profits must be returned even if the insider that obtained them engaged in no
wrongdoing. The SEC has no enforcement authority under Section 16(b) (Roszkowski
875).
In federal securities law, general “antifraud” provisions usually supplement the federal statutory requirements. The general antifraud provision for the 1934 Securities Act is Section 10(b). Section 10(b)-5 governs the antifraud provisions in insider trading. It prohibits the buying or selling of securities based upon access to confidential or proprietary information which is not available to the public. *The Matter of Cady, Roberts & Co.*, established the basic standards governing insider trading under Rule 10b-5. In *Cady, Roberts*, a corporate director called his broker in the middle of a Board of Director’s meeting to tell that the Board of Directors had decided to cut the dividend of the corporation. After receiving this information, the broker sold his customers’ shares. This information was not public yet, and as soon as the news came out, the price of the corporation’s stock plummeted. The SEC found the broker in violation of Rule 10b-5, and he was forced to pay damages. This case and subsequent cases made it clear that insiders possessing material, nonpublic information have an obligation to release this information or to abstain from trading (Roszkowski 879).

Insider trading regulations not only applies to the typical insider, but it also applies to employees, such as engineers, accountants who acquire material information from a corporate source. These persons are considered “temporary insiders.” Under 10b-5, liability also extends to tippees such as the broker in *Cady*, who used insider information to sell shares. A tipper is a person who passes on insider information but does not actually trade in the stock. A tippee is someone who acquires information from or through insiders who have breached their duties. The liability of tippees is determined by using the Dirks test. The Dirks test holds tippees liable if a) insiders have breached
their fiduciary duty to the corporation by disclosing that information and 2) the tippee knows or should know of that breach (Roszkowski 879-80).

The third type of outsider liability that exists is for “misappropriators.” Liability is imposed upon a person, who misappropriates (steals) non-public information, in violation of a fiduciary duty (owed to the source of information and then trades on that information). The duty is owed to the employer of the defendant and not the corporation. Unlike Rule 16 where the issuer (or shareholder acting on issuer’s behalf) can sue for damages, Rule 10b-5 gives the purchaser, or the seller of the security, and the SEC the right to act as plaintiffs. Although the U.S. Supreme Court has not explicitly accepted the misappropriation theory, several federal courts have adopted it.

To supplement Rule 10b-5, Congress enacted the Insider Trading Sanctions Act of 1984 and the Insider Trading and Securities Fraud Enforcement Act of 1988 to control insider trading. These statutes (1) require brokers, dealers, and investment advisors to implement systems that prevent insider trading, and to enforce policies designed to prevent misuse of material non-public information by the firm, its employers, or associated people, and (2) permit the SEC to recover a civil penalty from anyone that violates the 1934 Securities Act (Roszkowski 882).

**Past Landmark Cases**

In *SEC v. Texas Gulf Sulfur* (1965), the SEC went into court attempting to force repayment of insider profits not only by actual insiders, but those who obtained information from insiders that had not been publicly released. This was a landmark case where the SEC extended liability to the tipper and the tippee.
In another case, the SEC prosecuted Raymond Dirks, a securities analyst who had uncovered a massive fraud in the accounting policies of the Equity Funding Corporation. After finding out this information, Dirks told his customers about the scandal before it was released. However, the SEC was unsuccessful in their prosecution and Dirks prevailed because the Court found no liability. Dirks had not breached any fiduciary duty to the corporation by disclosing the fraud (Roszkowski 880).

Insider trading has been closely watched by the SEC ever since the crash in the 1930’s. Insider trading is legal as long as it obeys the rules set up by the SEC in the 1934 Securities Act. The gist of these rules state that an insider cannot trade on non-public information until that information is disclosed. They also cannot tip people off using non-public information. Most of the insider trade violations break one of these rules causing the SEC to take action. The SEC web site at www.sec.gov, lists current and past charges of illegal insider trading, and the number of cases pending are abundant. All the cases have the same fact pattern, and the results are similar. The SEC has made it clear that insider trading will not be tolerated. This is an attempt to level the trading grounds among insiders and investors.
BIBLIOGRAPHY
