EXCERPT FROM VOLUME ONE OF WILLIAM K.S. WANG & MARC I. STEINBERG, INSIDER TRADING (PLI 2D. ED. 2006).

CHAPTER ONE

Introduction

In this book, the term "insider trading" means trading by *anyone* (inside *or outside* of the issuer) on any type of material[1] nonpublic[2] 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

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[1] For the definition of "material" under §10(b) and rule 10b-5, see infra §4:2.

[2] For the definition of "nonpublic" under §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 the discussion of the "classical special relationship triangle" infra notes 34-38 and accompanying text; §§5:2.1, 6:7.

to use "insider trading" in this broad sense,[4] although the term may seem a misnomer.[5]

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

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[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). See also Note, Rule 10b-5 and the Evolution of Common Law Fraud--The Need for an Effective Statutory Proscription of Insider Trading by Outsiders, 22 Suffolk U. L. Rev. 813, 815 ("In recent years, insider trading has grown to include conduct by `outsiders,' or those individuals with no direct ties to the corporation in question.") (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."); Committee on Federal 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, 41 Bus. Law. 223, 224 (1985) ("`Insider trading' is, of course, a misnomer.").

[6] For a brief discussion of how these markets function, see

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]

This treatise analyzes the application of various laws to stock market insider trading and tipping. Among the federal laws are Exchange Act section 16, Exchange Act section 10(b), SEC rule 10b-5, mail/wire fraud, SEC rule 14e-3, and Securities Act section 17(a). The state laws discussed are the common law, the Uniform Securities Act, and the California and New York securities statutes.

Other chapters address government enforcement of the insider trading/tipping prohibitions and compare the harmful and allegedly beneficial effects of stock market insider trading.

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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 476-86 and accompanying text.

[9] See infra §3:3.1. For discussion of the related difficulty of drawing the line between "fortuitous" and "non-fortuitous" stock transactions, see infra §8.2.2.

Corporate law practitioners and others concerned with securities law compliance and prevention of illegal insider trading and tipping will be especially interested in chapter 13 ("Compliance Programs") and chapter 14 ("`Insider Trading' Under Section 16 of the Securities Exchange Act"). Chapter 13 suggests compliance programs for corporations, financial intermediaries, and professional firms.

Exchange Act section 16(a) requires statutorily defined "insiders" of certain corporations to report their beneficial ownership of the corporation's "equity securities" and the changes in these holdings.[10] Section 16(b) allows the corporation to recover the profits realized by these same insiders through a purchase and sale (or sale and purchase) of any "equity security" (of the corporation) within a period of less than six months.[11] Section 16(c) forbids short sales of the corporation's "equity securities" by these same statutorily defined insiders.[12] Section 16's restricted coverage limits its application to insider trading.

The interrelationship of many of the remaining chapters is 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

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[10] See infra §14:1.

[11] See id.

[12] See id.

publicly traded stock. The treatise examines the array of laws that cover the alleged misconduct.

The principal ones are the following "five fingers of federal fraud":

1. the section 10(b)/rule 10b-5 classical "special relationship" theory, endorsed by the Supreme Court.[13]

2. the section 10(b)/rule 10b-5 misappropriation doctrine, endorsed by the Supreme Court.[14]

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 broadened further.[15]

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[13] 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, 117 S. Ct. 2199, 2207 (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 549-53, 5:4.1[B], 9:3.3.

[14] See United States v. O'Hagan, 521 U.S. 642, 649-666, 117 S. Ct. 2199, 2206-2214 (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 549-53, 5:4.1[B], 9:3.3.

[15] For discussion of the federal mail and wire fraud statutes, see infra chapter 11.

4. SEC rule 14e-3, regulating insider trading and tipping in the context of tender offers.[16]

5. Securities Act section 17(a).[17]

One of the most important weapons is Exchange Act section 10(b)/SEC rule 10b-5. Initially, one must determine whether the accused's conduct met the many requirements of a section 10(b)/rule 10b-5 violation.[18] For example, was the information material[19] and non-public[20]? Did the individual have the

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[16] For discussion of SEC rule 14e-3, see infra chapter 9.

[17] For discussion of §17(a) of the Securities Act of 1933, see infra chapter 10.

For another concise description of the federal law regulating insider trading (including section 16), see Committee on Corporate Laws, Section of Business Law, American Bar Association, Corporate Director's Guidebook 79-82 (4th ed. 2004); Section of Business Law, American Bar Association, Corporate Director's Guidebook--2002-2003 Edition, 59 Bus. Law. 1057, 1108-1110 (2004). For an overview of the federal and state laws regulating insider trading, see Taylor, Teaching an Old Law New Tricks: Rethinking Section 16, 39 Ariz. L. Rev. 1315, 1319-1348 (1997). For a brief description of SEC Rule 10b-5's application to insider trading, see Haynes, *Insider Trading Under Rule 10b-5*, 29 ALI-ABA Bus. L. Course Materials J. #5, Oct. 2005, at 5.

[18] For discussion of some of these requirements, see infra §§4:1-4:6.

[19] For the definition of "material" under §10(b) and rule

requisite scienter[21]? Did the accused breach a duty to disclose under the two principal possible bases of section 10(b)/rule 10b-5 liability: the classical "special relationship" theory[22] and the misappropriation doctrine?[23] The Supreme Court has endorsed both the first approach[24] and the second.[25]

The courts use different terms to describe what this book calls the classical "special relationship" theory, or, more simply, the "special relationship" theory. In *Dirks v. SEC*[26], the Supreme Court referred to a "special relationship" between the insider trader and the party on the other side of the

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10b-5, see infra §4:2.

[20] For the definition of "nonpublic" under §10(b) and rule 10b-5, see infra §4:3.

[21] For discussion of scienter under §10(b) and rule 10b-5, see infra §4:4.

[22] For discussion of the classical "special relationship theory," see infra §§5:2, 5:3.

[23] For discussion of the misappropriation doctrine, see infra §5:4.

[24] See infra §5:2.1.

[25] United States v. O'Hagan, 521 U.S. 642, 649-666, 117 S. Ct. 2199, 2206-2214 (1997). See infra §§4:5.2[B], 5:4 & notes 549-53, 5:4.1[B]. For additional discussion of *O'Hagan*, see infra §§4:4.5, 9:3.3.

[26] 463 U.S. 646 (1983).

trade.[27] In his dissent in *Chiarella v. United States*,[28] Justice Blackmun said that the majority required a "special relationship."[29] The Second Circuit has employed the term "traditional theory" for the same concept.[30] Other circuit courts have used the phrase "classical theory."[31] In *United States v. O'Hagan*,[32] the Supreme Court referred to the

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[27] See *Dirks*, 463 U.S. at 656 n.15 ("And 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.").

[28] 445 U.S. 222 (1980).

[29] 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).

[30] See United States v. Chestman, 947 F.2d 551, 564-566 (2d Cir. 1991) (en banc), cert. denied, 503 U.S. 1004 (1992).

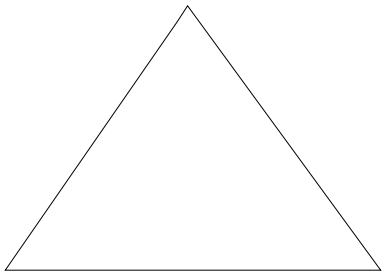
[31] See, e.g., SEC v. Maio, 51 F.3d 623, 631 (7th Cir. 1995); SEC v. Cherif, 933 F.2d 403, 408-409 (7th Cir. 1991), cert. denied, 502 U.S. 1071 (1992); SEC v. Clark, 915 F.2d 439, 443 (9th Cir. 1990).

[32] 521 U.S. 642 (1997).

"`traditional' or `classical theory' of insider trading liability."[33] All these terms are synonymous.

The classical "special relationship" is a triangle:

ISSUER (A) OF THE STOCK TRADED



EMPLOYEE/INDEPENDENT-CONTRACTOR TRADER/TIPPER (B-1) [TRADING OUTSIDER/TIPPEE (B-2); OUTSIDE TRIANGLE, BUT MAY BE PARTICIPANT AFTER THE FACT IN B-1'S VIOLATION]

INNOCENT PARTY ON OTHER SIDE OF TRADE (C) (ALREADY A S/H OR BECOMES ONE WITH THE TRADE)

[33] Id. at 641. See id. at 652 (employing the term "classical theory").

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 trade (which is based on material nonpublic information or while in possession of such information[34]). The "corporate insider" trader/tipper (B-1) is in the triangle usually because of his or her direct *or indirect* employment by the issuer (A).[35] The innocent party (C)

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[34] For discussion of "while in possession of material nonpublic information" versus "on the basis of material nonpublic information," see infra §4:4.5.

[35] For discussion of why employees (B-1) are in the 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]. 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* "special relationships" outside the classical special relationship triangle, see infra §§5.2.3.[F], 5.2.3[G], 5.2.3[H].

on the other side of the trade is in the triangle because of his or her ownership of stock of the issuer (A).

Because of their *mutual* relationship to the issuer (A), the "corporate insider" trader/tipper (B-1) and the party (C) on the other side of the trade have a special relationship. The special relationship creates a duty to disclose.[36]

Under the classical special relationship theory, a "corporate insider"/tipper (B-1) breaches his or her fiduciary duty by tipping only if he or she receives a *personal benefit* from the disclosure.[37] The outsider/tippee (B-2) enters the triangle if the "corporate insider"/tipper (B-1) 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.[38]

Many stock market insider traders or tippers may escape liability under the classical special relationship theory. One example is someone who is neither an employee of the issuer, the

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[36] For discussion of this classical special relationship triangle, see infra §5:2.1.

[37] For discussion of tipper liability under the classical special relationship theory, see infra §5:2.8.

[38] For discussion of tippee liability under the classical special relationship theory, see infra §5:3.

equivalent of an employee, nor a direct or indirect tippee of such an employee or employee-equivalent.[39]

To fill this gap, the Supreme Court has endorsed the misappropriation doctrine.[40] This theory bases section 10(b) and rule 10b-5 liability on a breach of duty to the information source.[41]

In August 2000, the Commission adopted rule 10b5-1, which provides that rule 10b-5 insider trading liability generally arises when someone trades while "aware" of material nonpublic information, but also provides certain exceptions from liability.[42] Rule 10b5-1(a) states:

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[39] For references to discussion of various other possible "special relationships" see supra note 35.

[40] See United States v. O'Hagan, 521 U.S. 642, 649-666, 117 S. Ct. 2199, 2206-2214 (1997). For discussion of *O'Hagan*, see infra §§4:4.5, 4:5.2[B], 5:4 & notes 549-53, 5:4.1[B], 9:3.3.

[41] 521 U.S. at 647, 117 S. Ct. at 2205 ("breach of a fiduciary duty to the source of the information"); 521 U.S. at 652, 117 S. Ct. at 2207 ("breach of a duty owed to the source of the information").

[42] For the full text of rule 10b5-1 and the accompanying release, see infra **Appendix 5A**, reprinting 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 of rule 10b5-1, see infra §§**4:4.5**, 4:5.3, 5:2.3[C][1] & nn.146-49, 5:2.3[G] n.326, 13:2.3 & n.48, 13:2.4, 13:3.3, 13:5.2.[C][3], 13:6.2[B] & nn.401-06.

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.[43]

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 www.sec.gov/interps/telephone/phonesupplement4.htm.

[43] See *Proposing Release*, supra note 42, Part III.A.2, at 82,860, text at note 86 (citing United States v. O'Hagan, 521

In criminal prosecutions of insider trading or tipping, the federal mail and wire fraud statutes are another major weapon. In *Carpenter v. United States*,[44] 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" include schemes "to deprive another of the intangible right of honest services."[45] This amendment enlarged the already broad sweep of mail/wire fraud and increased further its importance in 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.[46] Section 17(a) of the Securities Act of 1933 prohibits fraud in

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U.S. 642 (1997), Dirks v. SEC, 463 U.S. 646 (1983); Chiarella v. United States, 445 U.S. 222 (1980)).

[44] 484 U.S. 19, 25-28 (1987). *Carpenter* is discussed in several sections of chapter 11, including §§11:3.1, 11:3.2[A].

[45] 18 U.S.C. §1346, as amended by Pub. L. No. 100-690 (1988), 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."

[46] See infra chapter 9.

the offer or sale of securities, including negligent conduct.[47] This latter statutory provision is broad enough to cover some *selling* on insider information or tipping of *bearish* nonpublic news.[48]

The book also examines the civil and criminal remedies and penalties the government might seek to impose on the defendant.[49]

Regardless of Justice Department or SEC action, private civil plaintiffs may sue an accused insider trader or tipper. The treatise describes some elements of private civil liability, including the remedies obtainable.[50]

Plaintiffs may have either an express or an implied private action under various federal statutes and rules. Securities Exchange Act section 20A creates an *express* private action for contemporaneous traders suing someone whose insider trade or tip violates the Exchange Act or its rules,[51] including section 10(b)/rule 10b-5 and rule 14e-3.

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[47] See infra §§10:1, 10:3.

[48] See infra §§10:1, 10:3, 10:4. For general discussion of §17(a)'s application to stock market insider trading and tipping, see infra chapter 10.

[49] See infra chapter 7.

[50] See infra §§4:7 - 4:9.

[51] For discussion of §20A's limitation to violations of the Exchange Act and its rules, see infra §10:7.

The Supreme Court has recognized an implied private cause of action under section 10(b) and rule 10b-5,[52] but has not ruled whether such causes of action exist under mail/wire fraud, Securities Act section 17(a), or SEC rule 14e-3. The lower courts, however, have uniformly held that a private right of action does not exist under the mail fraud or wire fraud statutes.[53] The clear trend in recent circuit court opinions is to refuse to imply such a suit under Securities Act section 17(a).[54] Whether an implied private action exists under SEC rule 14e-3 is unclear[55]; nevertheless, Exchange Act section 20A creates an *express* private action against rule 14e-3 violators.[56]

As mentioned earlier,[57] section 16(b) expressly allows certain corporations to recover the "short-swing" profits of

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[52] See Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson, 501 U.S. 350, 358 (1991) ("this Court repeatedly has recognized the validity of such claims") (citations omitted); 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) ("the existence of a private cause of action . . . is now well established") (citations omitted).

[53] See infra §11:1 note 17 and accompanying text.

[54] See infra §10:5.

[55] See infra §9:4.2.

[56] See infra §§6:2, 9:4.2.

[57] See supra text accompanying note 11.

statutorily defined insiders who trade the company's "equity securities." Section 16(b)'s cause of action is available only in extremely limited circumstances.[58]

One chapter describes the approach to insider trading and tipping of the American Law Institute's Federal Securities Code.[59] Congress has not adopted this Code.

In addition to federal law, state law may apply. This treatise discusses whether an alleged insider trader violates state common law, the Uniform Securities Act, the New York securities statute, or the California securities statute.[60]

Two chapters examine the justification for the regulation of stock market insider trading. These chapters may be of special interest to academics in law and other disciplines. One chapter analyzes the alleged benefits and detriments to society of stock market insider trading.[61]

Another chapter discusses the harm to individual investors from insider trading in an impersonal stock market.[62] Each stock market insider trade has specific victims, although they are unidentifiable in practice. 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

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[58] For discussion of §16(b), see infra chapter 14.

[59] See infra chapter 8.

[60] See infra chapter 15.

[61] See infra chapter 2.

[62] See infra chapter 3.

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 someone 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 someone is worse off because of the insider trade. This book calls this phenomenon "the law of conservation of securities."[63]

In summary, as a supplement to both state law and Exchange Act section 16, the principal weapons against stock market insider trading and tipping consist of "five fingers of federal fraud"[64]: 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).

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[63] See infra §3:3.5.

[64] See supra notes 13-17 and accompanying text.