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Legal Risk Management Tip
August 2012

PRACTICAL CONSIDERATIONS FOR PREVENTING INSIDER TRADING

Enforcement actions by the Securities and Exchange Commission ("SEC") in 2012 are up, which, according to a recent study, is in large part due to increased allegations relating to insider trading.[1] Through June of this year, the SEC has announced settlements in 60 insider trading cases, compared with a total of 63 in all of 2011.[2] In light of this increased enforcement, financial institutions should revisit this critical area to ensure that internal controls and effective policies and procedures are in place to curb abuse and protect the firm and its clients from insider trading violations.

I. What is Insider Trading?

The term "insider trading" refers to unlawful trading in a security by a person who possesses material non-public information about an issuer. There are a number of insider trading theories under which individuals can be prosecuted. The classic theory of insider trading is commonly referred to as "abstain or disclose." Under this rule, settled by the U.S. Supreme Court in the landmark decision *Chiarella v. United States*,[3] a violation of SEC Rule 10b-5[4] occurs when a person who owes a fiduciary duty to the marketplace trades on material nonpublic information without disclosing that information. As a matter of law, a corporate employee owes a fiduciary duty directly to its employer and indirectly to the employer's shareholders. Therefore, if a corporate employee makes a trade based on his possession of material information without disclosing it, he has committed insider trading in violation of Rule 10b-5.

Under another theory commonly referred to as the "misappropriate theory," it is not the insider himself trading on the information (the "tipper"), but rather, someone that he tips (the "tippee"). While the receipt of non-confidential information from an insider does not impose the abstain or disclose obligation on the tippee, the tipper *and* the tippee may still be held liable for insider

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[1] Overdahl & Buckberg, NERA Economic Consulting, SEC Settlement Trends: 1H12 Update (June 27, 2012) (available at: http://www.securitieslitigationtrends.com/PUB_SEC_Trends_Update_0612.pdf).
[2] *Id*.
[3] 445 U.S. 222 (1980)
[4] Rule 10b-5 states:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
> (a) To employ any device, scheme, or artifice to defraud,
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,
> in connection with the purchase or sale of any security.

17 C.F.R. 240.10b-5.

trading under a theory of misappropriation. Accordingly, liability attaches if the tipper/insider breaches a duty by passing on the information, and the tippee knows or has reason to know that the tipper/insider would benefit personally from the tip. Importantly, the Supreme Court has adopted an expansive interpretation of what constitutes a "personal benefit" to the insider, including situations where the insider is enhancing his own reputation by tipping and "when an insider makes a gift of confidential information to a trading relative or friend."[5] In the latter situation, the Supreme Court has explained that the "tip and trade resemble trading by the insider himself followed by a gift of the profits to the recipient." *Id*. As a practical matter, the important questions are (1) whether conveying the information constituted an apparent breach of duty, and (2) whether the tipper received any benefit (financially or otherwise) from providing the tip. If so, the tippee "assumes an insider's duty to the shareholders not because they received insider information, but rather because it has been made available to them *improperly*."[6]

While the abstain and disclose and misappropriation theories are essentially based in federal common law, a third avenue of insider trading prosecution is found in SEC Rule 14e-3. Rule 14e-3 prohibits any person who is in possession of material nonpublic information relating to the commencement of a tender offer, acquired directly or indirectly from the offeror or target companies (or their officers, directors, employees, etc.), from trading in the securities of the target.[7] The Rule also specifically outlaws such individuals from communicating material nonpublic information to "any other person under circumstances in which it is reasonably foreseeable that such communication is likely to result in a violation…"[8] Unlike the other two theories, a breach of fiduciary duty is *not* required.[9]

II. Recent Abuses

From 2003-2011, the SEC settled between 104 and 66 insider trading enforcement actions per year. This year, the Commission is on pace to settle over 120 actions. Federal prosecutors meanwhile have been in the spotlight recently for high profile insider trading cases and increased prosecutions. Indeed, the FBI reports a dramatic 40% increase in insider trading cases over the past year.

Undoubtedly the highest profile insider trading case in recent history is the conviction of Raj Rajartnam, the general partner of Galleon Management, L.P. After an eight week jury trial, Rajartnam was found guilty of 14 counts of conspiracy and securities fraud related to profiting from information he received from others at hedge funds, public companies and investor relations firms, including Goldman Sachs, Intel, IBM, McKinsey & Company, and Moody's Investor Services, Inc. Last October Rajartnam was sentenced to 11 years in prison – the longest prison sentence ever handed out for insider trading. Thirteen other defendants connected to

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[5] *Dirks v. SEC*, 463 U.S. 646, 664 (1983).
[6] *Id*. at 661 (emphasis in the original).
[7] 17 CFR §240.14e-3(a).
[8] 17 CFR §240.14e-3(d)(1).
[9] There are additional types of violations. Section 16(b) of the Securities Exchange Act of 1934 was designed to prevent insider trading and gives an issuer (or shareholders derivatively) the right to recover any profit made by an officer, director or controlling shareholder from purchases and sales that occur within six months of each other. A few states have developed a common law theory that allows corporations (or, again, shareholders derivatively) to recover profits made by an insider trading in its stock as a result of material nonpublic information and California has its own statutory protection.

Rajartnam's case received prison sentences averaging three years. Rajartnam's, and the other defendants' conduct, was obviously devastating to the fund and it disintegrated upon his arrest in 2009.

Another settlement of note was announced by the SEC in April. In that case attorney Matthew H. Kluger participated in an unlawful insider trading scheme perpetrated over 18 years. Kluger worked as an attorney at some of the largest and most prestigious corporate law firms in the nation and used inside information gained initially from his own work on corporate transactions, and then later from documents housed on the law firm's internal systems, to tip registered representative Garret D. Bauer. Kluger was sentenced to 144 months in prison while Bauer received a 108 month prison term. Both were ordered to disgorge their ill-gotten profits, over $31 million between them and a third defendant, Kenneth T. Robison, who received no prison sentence as a result of his cooperation with the SEC. Bauer, who traded ahead of more than 30 different corporate transactions based on tips received from Kluger, was also barred from the industry. Kluger likewise was prohibited from practicing before the SEC as a result of the settlement.

III. Protecting Against Violations

For those in the financial industry, having effective insider trading policies within the organization is mandatory. In addition to the obvious and necessary step of articulating a clear policy banning insider trading, the best preventive measure is monitoring the trading activity of supervised persons at a level that is commensurate with the size and trading activity of the firm.

The first step in appropriate monitoring is identification of associated individuals, such as research analysts and broker or advisers with corporate insider clientele, who could potentially come in contact with inside information. Once these individuals are identified, firms must provide adequate training of how and what constitutes insider trading. Next, reporting and monitoring procedures for trading activity by all associated persons should be implemented. Depending on the size of the institution such procedures can be automated, and various software solutions implemented to monitor for unusual trading activity. Technology certainly plays apart in enforcement, and should undoubtedly be leveraged by firms to effectively detect insider trading threats and spot potentially fraudulent conduct. Collectively, these steps can help an organization develop reasonable safeguards to minimize the threat of insider trading.

For more information about this topic and other legal services, please contact us at (619) 298-2880, info@jackolg.com or visit www.jackolg.com. Thank you.

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