

**TELLING THE TRUTH SLANT – DEFENDING INSIDER
TRADING CLAIMS AGAINST LEGAL AND FINANCIAL
PROFESSIONALS**

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Tell all the Truth but tell it slant —
Success in Circuit lies
Too bright for our infirm Delight
The Truth's superb surprise
As Lightning to the Children eased
With explanation kind
The Truth must dazzle gradually
Or every man be blind –

Emily Dickinson

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I. INTRODUCTION.

Insider trading cases against legal and financial professionals tend to be hotly litigated disputes over factual rather than legal issues. Defending these cases requires a persuasive, slanted presentation that explains in a consistent and credible manner the defendant's conduct and transactions and supports the defendant's good faith in the face of what is ordinarily a multi-layered but exclusively circumstantial case that the defendant engaged in fraudulent and deceptive securities transactions.

II. BACKGROUND.

A. *The Development of Insider Trading Liability.*

Insider trading liability may arise in the context of criminal, civil or administrative proceedings. The U.S. Department of Justice has jurisdiction to pursue criminal actions. The Securities and Exchange Commission (SEC), self-regulatory agencies, and state securities enforcement agencies may initiate civil and administrative proceedings based on insider trading allegations. Private parties may also bring civil claims based on insider trading allegations.

Insider trading claims are frequently pursued against classic insiders - officers and directors of corporations, who in the regular course of their duties have access to material, nonpublic information. Professionals assisting those corporations, officers and directors—lawyers, investment bankers and other financial advisors—frequently have access to this same information in the normal course of providing professional services. Indeed, it is not surprising that many insider trading claims are brought against these professionals, who are sometimes characterized as “temporary insiders” by virtue of their temporary access to inside information.¹

1. *The Traditional or Classical Theory.*

Insider trading liability is ordinarily based on a violation of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-

1. See Robert S. Karmel, *Insider Trading: Law, Policy and Theory after O'Hagan*, 20 CARDOZO L. REV. 83, 84 n.6 (1998) (“Attorneys, more than any other group, have been prosecuted for insider trading.”). *Id.*

5 thereunder.² Liability for trading on inside information is usually premised on Rule 10b-5's ban on fraudulent acts or practices. "Under the 'traditional' or 'classical' theory of insider trading . . . Rule 10b-5 [is] violated when a corporate insider trades in [that corporation's securities] on the basis of material, nonpublic information."³

Initially, the prohibition against insider trading was articulated as a "disclose or abstain" rule. This rule required a corporate insider with a fiduciary duty to the corporation and its shareholders to either disclose material, inside information or abstain from trading in the corporation's stock. That rule was first stated in *Cady, Roberts & Co.*,⁴ where the SEC found a director of a company passing on an inside tip had violated the obligation to "disclose or abstain." In that case, the director, who was also a broker, recommended that his customers sell the company's stock based on a tip from a corporate insider of a dividend cut. The SEC noted the existence of a relationship allowing access to inside information intended only for a legitimate corporate purpose, and the unfairness of permitting an insider to take advantage of that information by trading without disclosure.⁵ The Second Circuit Court of Appeals and ultimately, the U.S. Supreme Court, subsequently endorsed this "disclose or abstain" rule.⁶

The U.S. Supreme Court subsequently found that, in a face-to-face transaction, a buyer with inside information about a company has a duty to disclose such information to the seller before consummating a transaction.⁷

At least initially, the scope of insider trading liability was fairly limited, and only applicable in situations where the insider had a fiduciary duty to the party with whom the insider traded, or to the

2. See 15 U.S.C. § 78j(b) (2001); 17 C.F.R. § 240.10b-5 (2001). Insider trading liability under federal securities law may also be predicated on section 14(e) of the Securities Exchange Act of 1934 and Rule 14e-3 thereunder (concerning tender offers), and Section 16 of the Securities Exchange Act of 1934 (concerning short-swing profits). Insider trading liability may also arise from violation of state blue sky laws.

3. *United States v. O'Hagan*, 521 U.S. 642, 651-52 (1997).

4. *Cady, Roberts & Co.*, Securities Exchange Act of 1934, Release No. 34-6668, 40 SEC 907 (Nov. 8, 1961).

5. *Id.* at 917-918.

6. See *Chiarella v. United States*, 445 U.S. 222, 226-227 (1980); *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 848 (2d Cir. 1968).

7. *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128, 152-53 (1972).

corporation, or shareholders of the corporation, whose securities were traded. That is, absent a fiduciary relationship, trading on material, non-public information did not create insider trading liability.

The Supreme Court first examined this requirement of a fiduciary relationship in an insider trading case in *Chiarella v. United States*.⁸ In that case, a printing firm was hired to produce documents for various tender offers.⁹ The target company's identity was concealed in the galleys.¹⁰ Chiarella, a printer employed by the firm, was able to identify the target company by reading the other information in the tender offer materials, and he proceeded to purchase the target company's stock.¹¹ The Court found Chiarella had no legal duty to the target company, absent a wrongful conversion or misappropriation, and therefore did not violate the insider trading laws.¹² Significantly, the Court expressly did not determine whether Chiarella breached a duty to his employer, the printer.¹³

Generally, a public company is not required to promptly disclose all material corporate developments.¹⁴ Moreover, as the *Chiarella* Court recognized, there is no general ban on trading on non-public information, even without disclosure.¹⁵ For example, brokers and their clients can trade on the basis of lawfully obtained non-public information, and this information advantage is thought to contribute to an efficient market.¹⁶

The "disclose or abstain" rule was subsequently extended to third party "tippees" - individuals who trade based on tips from insiders. In *Dirks v. SEC*,¹⁷ the Court held that a tippee violates Rule 10b-5 when the insider who disclosed this information did so in violation of the insider's fiduciary duty to the company or its shareholders.¹⁸ In this case, Dirks, an investment analyst, investigated a company and determined that the company's assets

8. 445 U.S. 222 (1980).

9. *Id.* at 224.

10. *Id.*

11. *Id.*

12. *Id.* at 232-33.

13. *Id.* at 235-37.

14. Karmel, *supra* note 1, at 119.

15. *Chiarella*, 445 U.S. at 234 n.16.

16. *See Chiarella*, 445 U.S. at 233.

17. 463 U.S. 646 (1983).

18. *Id.* at 660.

had been fraudulently inflated.¹⁹ He disclosed this to the Wall Street Journal, which refused to publish, but word spread to investors.²⁰ The stock fell more than \$10 during a two-week period.²¹ The Court found that “a tippee assumes a fiduciary duty to . . . shareholders of a corporation . . . when the insider has breached his fiduciary duty to the shareholders” and “the tippee knows or should know that there has been a breach.”²²

In an oft-cited footnote, the Court also said:

Under certain circumstances, such as where corporate information is revealed legitimately to an underwriter, accountant, lawyer, or consultant working for the corporation, these outsiders may become fiduciaries of the shareholders. The basis for recognizing this fiduciary duty is not simply that such persons acquired nonpublic corporate information, but rather that they have entered into a special confidential relationship in the conduct of the business of the enterprise and are given access to information solely for corporate purposes For such a duty to be imposed, however, the corporation must expect the outsider to keep the disclosed nonpublic information confidential, and the relationship at least must imply such a duty.²³

The Court emphasized, however, that a fiduciary duty arises not merely when such persons have acquired material, nonpublic information, but because they have entered into a special, confidential relationship and are provided access to information solely for legitimate corporate purposes.²⁴

In sum, these cases recognize that a fiduciary relationship arises between a corporate insider and the corporation and its shareholders, as a result of the insider’s employment as an officer or director for the corporation. Under these circumstances, an insider with material, non-public information has the obligation either to disclose the information, or abstain from trading in the corporation’s securities. Professionals who obtain such information from insiders in the regular course of their employment, and tippees with knowledge that the insider tipper

19. *Id.* at 649-50.

20. *Id.*

21. *Id.*

22. *Id.* at 660.

23. *Id.* at 655 n.14 (citations omitted).

24. *Id.* at 654.

has breached a fiduciary duty to the corporation by passing on inside information, have the same obligations as insiders under this rule.

2. *The Misappropriation Theory.*

The traditional or classical theory of insider trading liability does not encompass circumstances where a person who is not a corporate insider (and furthermore, not a tippee or a professional who obtains the information while providing professional services to the corporation) trades the corporation's securities on the basis of material, nonpublic information obtained in a manner that did not involve an insider's breach of a fiduciary duty. The "disclose or abstain" rule does not apply to situations where the trader obtains the information from sources other than the corporation whose securities are traded, or where there is no breach of a fiduciary duty to that corporation.

Because of this limitation, aggressive prosecutors and regulators sought to expand the scope of insider trading liability to situations where the trader obtained material, non-public information by breaching a fiduciary duty other than a duty owed to the corporation whose securities are traded. This broader theory of insider trading liability—called "the misappropriation theory"—bars trading by an insider even when the securities being traded are not those of the insider's employer. Under this theory, a person violates Rule 10b-5 by misappropriating someone else's information in breach of a fiduciary duty owed to the source of the information (rather than the company whose stock is being traded).

The misappropriation theory departs significantly from the narrow "disclose or abstain" rule. Under this rule, fraud consists of the deception inherent in a securities transaction where the insider conceals important information from the other party to the transaction. The focus is on the relationship between the insider and the other trader. The misappropriation theory, by contrast, does not restrict itself to the fraud perpetrated on those who buy from or sell to the inside trader. Instead, it broadens the inquiry to determine whether the "insider" has obtained the material, non-public information wrongfully - in breach of a duty owed to the source of the information.

For example, in *United States v. Elliott*,²⁵ Elliot, a former law firm partner, was successfully prosecuted based on the misappropriation theory.²⁶ Elliott learned confidential non-public information about the planned acquisition of a large block of stock and subsequently purchased stock in the target company.²⁷ The government proceeded under the misappropriation theory.²⁸ The court adopted the theory, finding that the statute's language was broad enough to cover misappropriation as a violation of section 10(b).²⁹ The court characterized attorneys as "quasi-insiders," and found a fiduciary relationship between the shareholders of a corporation and the corporation's lawyer when corporate information is revealed legitimately and solely for corporate purposes.³⁰ The court noted that, before a fiduciary duty can be deemed to exist, "the corporation must expect the [attorney] to keep the disclosed nonpublic information confidential, and the relationship . . . must imply such a duty."³¹

As a further example, in *SEC v. Willis*,³² a psychiatrist tipped his broker some inside information he had received from a patient.³³ With this inside information, the broker tipped friends and traded in the accounts of several customers.³⁴ The Court rejected the broker's motion to dismiss, finding that the broker knew or was reckless in not knowing that the information had been misappropriated in breach of the psychiatrist's duty to his patient, and it was irrelevant for purposes of establishing insider trading liability that the patient was not herself a party to the securities transaction.³⁵

25. 711 F. Supp. 425 (N.D. Ill. 1989).

26. *Id.* at 432.

27. *Id.* at 425-26.

28. *Id.* at 430.

29. *Id.* at 431-32.

30. *Id.* at 432.

31. *Id.*

32. 777 F. Supp. 1165 (S.D.N.Y. 1991).

33. *Id.* at 1168.

34. *Id.*

35. *Id.* at 1172. *See also* *United States v. Falcone*, 97 F. Supp. 2d 297 (E.D.N.Y. 2000). In *Falcone*, a securities broker profited from stock information received from the friend of a business magazine's employee. *Id.* at 300. The employee had access to a business magazine containing information and advice about publicly held companies. *Id.* The employee gained access to the magazine prior to public dissemination. *Id.* The broker was found guilty despite the lack of a clear fiduciary duty between the broker and tipper. *Id.* at 301-02; *See also* *SEC v. Singer*, 786 F. Supp. 1158, 1161-62 (S.D.N.Y. 1992) (explaining how lawyer used

Tippees who receive misappropriated information may be liable for insider trading under the misappropriation theory even if the tipper - the provider of the misappropriated information - did not trade on that information. Tippee liability is imposed upon proof of "a breach by the tipper of a duty owed to the owner of the material nonpublic information and the tippee's knowledge that the tipper had breached the duty."³⁶

The U.S. Supreme Court endorsed the misappropriation theory for the first time in *United States v. O'Hagan*.³⁷ In that case, O'Hagan was an attorney whose firm was retained by Grand Metropolitan PLC in connection with a proposed acquisition of the Pillsbury Company.³⁸ Before Grand Metropolitan publicly announced its tender offer for Pillsbury stock, O'Hagan purchased 2,500 Pillsbury call option contracts and approximately 5,000 shares of Pillsbury common stock.³⁹ O'Hagan realized a profit of over \$4 million from these transactions.⁴⁰ Since O'Hagan was not an "insider" of Pillsbury, the corporation in whose shares he traded, the government proceeded against O'Hagan under the misappropriation theory.⁴¹

The government claimed that O'Hagan breached a fiduciary duty to his law firm and Grand Metropolitan when, through his employment at the law firm, he obtained material, non-public information concerning Grand Metropolitan's interest in acquiring Pillsbury, and subsequently used that information as a basis for trading in Pillsbury securities. The Supreme Court agreed that the misappropriation theory is a permissible basis for imposing section 10(b) liability.⁴²

The *O'Hagan* Court left open the question of the type of relationship that creates a fiduciary duty for insider trading purposes. Presumably, a fiduciary duty often exists between an employee and an employer, and a professional and a client. It is not clear whether this duty exists in other relationships, especially

confidential client information to trade in non-client's stock). See generally Stephen M. Bainbridge, *Insider Trading Under the Restatement of the Law Governing Lawyers*, 19 J. CORP. L. 1 (1993).

36. *United States v. Libera*, 989 F.2d 596, 600 (2d Cir. 1993); see also *United States v. Falcone*, 257 F.3d 226, 232 (2d Cir. 2001);

37. 521 U.S. 642 (1997).

38. *Id.* at 647.

39. *Id.* at 647-48.

40. *Id.* at 648.

41. *Id.* at 649.

42. *Id.* at 653.

non-business relationships, such as between family members or between friends.

In August 2000, the SEC implemented a new rule addressing this issue. The SEC's new Rule 10b5-2 clarifies how the misappropriation theory applies to certain non-business relationships.⁴³ Under this rule, a person receiving confidential information could be liable under the following circumstances:

- a. The person agreed to keep the information confidential;
- b. The persons involved in the communication had a pattern or practice of sharing confidences that resulted in a reasonable expectation of confidentiality; or
- c. The person providing the information was a spouse, parent, child, or sibling of the person receiving the information.⁴⁴

B. Materiality.

Trading on inside information is prohibited only if that information is material. Theoretically, materiality is determined as of the time of the trade. Of course, that determination is made after-the-fact, by a fact-finder with full knowledge of the events occurring after the trade. It is difficult, as a practical matter, for that fact-finder not to be influenced by hindsight.

The U. S. Supreme Court has defined materiality as follows:

An omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to [act] Put another way, there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available.⁴⁵

At the time of the trade, it may be extremely difficult to determine whether particular inside information is material. If an individual makes a trade solely on the basis of that information, it is fair to assume that the information was material to that individual. Presumably, under those circumstances, the individual acted on that information, and considered the information important enough to rely upon it making an investment. In most cases,

43. 17 C.F.R. § 240.10b5-2 (2000).

44. *Id.*

45. *TSC Indus. v. Northway*, 426 U.S. 438, 449 (1976); *see Basic Inc. v. Levinson*, 485 U.S. 224, 231-32 (1988) (adopting the *TSC Indus.* standard of materiality for § 10(b) and Rule 10b-5).

however, there are myriad reasons why an investor makes an investment at a particular time.

Because the standard for determining materiality is the "reasonable shareholder," materiality is often a fact-bound determination. Motions for judgment on the pleadings and summary judgment are rarely granted, and the decision on materiality is ordinarily reserved for the fact-finder.

Recent cases suggest some guidelines for determining materiality. For example, in *Berreman v. West Publishing Co.*,⁴⁶ the Minnesota Court of Appeals held that a company's retention of an investment banker for purposes of exploring restructuring or merger alternatives is *not* material nonpublic information for securities law purposes.⁴⁷

In *Berreman*, Thomas Berreman, was a long-time West Publishing Co. employee who owned some of that company's closely-held common stock.⁴⁸ In April 1995, Berreman told West's Chief Executive Officer that he intended to retire effective June 1, 1995.⁴⁹ His last day of work was May 31, 1995, and on June 1, 1995, Berreman redeemed his 1,600 shares of West common stock at the then-current book value of \$2,088.90 per share.⁵⁰

When he redeemed his shares on June 1, 1995, Berreman was not aware of these events: 1) during the second week of May 1995, West's Chief Financial Officer concluded that West should consider being acquired or enter into a joint venture; 2) on May 17, 1995, West's directors met with an investment banking firm to obtain advice about the company's future financial options, including a possible sale of the company, and 3) on May 23, 1995, the West board authorized its investment bankers to explore financing options beyond West's local bank.⁵¹ Subsequently, on August 29, 1995, West publicly announced that it had engaged investment bankers and was considering alternative financial options.⁵² In September 1995, West sent out requests for bids to potential acquirers.⁵³ In February, 1996, West entered into a merger

46. 615 N.W.2d 362 (Minn. Ct. App. 2000).

47. *Id.* at 375.

48. *Id.* at 366.

49. *Id.*

50. *Id.*

51. *Id.*

52. *Id.* at 366-67.

53. *Id.* at 367.

agreement with Thomson Corporation.⁵⁴ In June 1996, Thomson paid \$10,445 per share to acquire West.⁵⁵

Based on these facts, Berreman claimed that West and three of its directors breached fiduciary duties owed to him, and that they committed fraud.⁵⁶ Berreman's claims required the court to consider when preliminary merger discussions become "material" for purposes of fraud. Drawing upon the analysis set forth in *Basic Inc. v. Levinson*⁵⁷ and other federal securities law cases, the court stated that the test for materiality required a balancing of both the "indicated probability that the event will occur and the anticipated magnitude of the event in light of the totality of the company activity."⁵⁸ Applying that balancing test, the court held that a corporate decision to explore restructuring options, including the possible sale of the company, coupled with the retention of an investment banker, was immaterial as a matter of law.⁵⁹

As another example, in *SEC v. Thrasher*,⁶⁰ the court in denying summary judgment, rejected the defendant's claim that he could not be liable for insider trading on the basis of a false rumor from an unreliable tipper.⁶¹ The defendant asserted that the information provided by the tipper proved largely false, and was inherently immaterial since the tippers were a nightclub promoter and a male prostitute dying of AIDS, both reputed to be dishonest and desperate for money.⁶² The SEC responded that the defendant's behavior - researching and then purchasing the securities after receiving the information from the purportedly unreliable sources - indicated he did believe them.⁶³ The Court noted that "[a] major factor in determining whether information was material is the importance attached to it by those who knew about it."⁶⁴ Accordingly, the Court determined that a reasonable jury could find that the information was material.⁶⁵

54. *Id.*

55. *Id.*

56. *Id.* at 371.

57. 485 U.S. 224, 231 (1988).

58. *Berremen*, 615 N.W.2d at 371-72 (quoting *Basic Inc. v. Levinson*, 485 U.S. 224, 238 (1988)).

59. *Id.* at 373.

60. 152 F. Supp. 2d 291 (S.D.N.Y. 2001).

61. *Id.* at 305.

62. *Id.* at 299.

63. *Id.* at 300.

64. *Id.* (quoting *SEC v. Mayhew*, 121 F.3d 44, 52 (2d Cir. 1997)).

65. *Id.* at 301.

C. *Non-public Information.*

Trading on material, inside information is prohibited only if that information is truly nonpublic. "To constitute non-public information under the [1933 Securities Exchange] Act, information must be specific and more private than general rumor."⁶⁶ There is no securities law violation where "the disclosed information is so general that the recipient thereof is still "undertaking a substantial economic risk that his tempting target will prove to be a 'white elephant.'"⁶⁷ However, an insider's confirmation of rumors that a company is in actual merger discussions, even if no specific details of the merger are provided, constitutes a tip of material non-public information.⁶⁸

D. *The Intent to Defraud.*

Scienter is a necessary element of a securities fraud violation. Scienter means the intent to deceive, manipulate or defraud.⁶⁹ Recklessness satisfies this scienter element, but is limited to

those highly unreasonable omissions or misrepresentations that involve not merely simple or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and that present a danger of misleading buyers or sellers which is either known to the defendant or is so obvious that the defendant must have been aware of it.⁷⁰

As a practical matter, concealment by the defendant before and after the transaction is often the basis for proving scienter. A defendant who denies or attempts to conceal the existence of relationships or communications, and especially the fact of a transaction will find it more difficult to demonstrate good faith and defend against the claim that his activities were made with the

66. SEC v. Mayhew, 121 F.3d 44, 49 (2d Cir. 1997) (quoting United States v. Mylett, 97 F.3d 663, 666 (2d Cir. 1996)).

67. *Id.* at 52 (citations and internal quotations marks omitted).

68. *Id.* (citing United States v. Mylett, 97 F.3d 663, 667 (2d Cir. 1996)).

69. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 n.12 (1976).

70. K & S P'ship v. Cont'l Bank, N.A., 952 F.2d 971, 978 (8th Cir. 1991) (quoting Woods v. Barnett Bank of Fort Lauderdale, 765 F.2d 1004, 1010 (11th Cir. 1985) (quoting Broad v. Rockwell Int'l Corp., 642 F.2d 929, 961-62 (5th Cir.) (en banc), cert. denied, 454 U.S. 965 (1981))); see Alpern v. Utilicorp United, Inc., 84 F.3d 1525, 1534 (8th Cir. 1996) (stating that recklessness satisfies scienter requirement); SEC v. Falbo, 14 F. Supp. 2d 508, 530 (S.D.N.Y. 1998) (stating that recklessness satisfies scienter requirement in a civil enforcement action).

intent to defraud.

E. Causation - the Use and Possession Controversy.

There is a controversy whether Rule 10-5 liability requires proof of a causal connection between the material inside information and the insider's trading. In other words, does insider trading liability require proof that the trader actually "used" material nonpublic information in trading or merely that the trader had "knowing possession" of the information before trading?

Some courts have required proof of actual use.⁷¹ At least one court has adopted the more lenient position promoted by the SEC, and required only proof of knowing possession.⁷²

In *Adler*, the SEC brought a civil action against a corporate officer of Comptronix Corporation, alleging insider trading and seeking treble damages.⁷³ The officer had attended a board meeting where it was reported that Comptronix anticipated its largest customer would completely terminate or largely reduce its orders of product.⁷⁴ After the meeting, the officer proceeded to sell 20,000 out of his 869,897 shares of stock.⁷⁵

The officer brought a motion for summary judgment, asserting that he had sold his shares as part of a preexisting plan, not as a result of material non-public information.⁷⁶ He introduced evidence that he had discussed with his stock broker his plan to sell the stock before the board meeting, and had also obtained approval for the sale from the company's general counsel.⁷⁷ In addition, he sold the stock on the last day of the lockup period for Comptronix's initial public offering. The district court granted the defendant's motion for summary judgment, determining that the officer had rebutted any reasonable inference that he acted with the requisite scienter.⁷⁸

On appeal, the Eleventh Circuit reversed the grant of summary judgment in favor of the officer, but rejected the SEC's argument that mere possession of non-public information by an insider who

71. *United States v. Smith*, 155 F.3d 1051, 1066-67 (9th Cir. 1998); *SEC v. Adler*, 137 F.3d 1325, 1342-43 (11th Cir. 1998).

72. *United States v. Teicher*, 987 F.2d 112, 120 (2d Cir. 1993).

73. *Adler*, 137 F.3d at 1327-32.

74. *Id.*

75. *Id.* at 1329.

76. *Id.*

77. *Id.*

78. *Id.*

trades in the company's stock is sufficient to establish liability under Section 10(b).⁷⁹ The court concluded that the "in connection with the purchase or sale of a security" requirement of Section 10(b) "suggests a focus on fraud, deception, and manipulation" and that the "use standard" "best comports" with this language.⁸⁰ The court reasoned that the "use" test is appropriate because it is only in trading on the basis of material nonpublic information that an insider breaches any fiduciary duty and derives personal gain.⁸¹

The *Adler* court recognized that it is often difficult to prove that an insider actually uses material non-public information to trade. In an effort to alleviate this problem, the court created a refutable evidentiary presumption that an insider uses material non-public information when he is in possession of such information and then trades.⁸²

Smith came to a similar resolution in an appeal from a criminal conviction in an insider trading case.⁸³ The appellate issue related to the adequacy of a jury instruction that the government did not need to prove that the defendant sold his stock solely because of material nonpublic information, but rather that such information was a significant factor in the defendant's decision to sell. The Ninth Circuit found the jury instruction to be adequate, but rejected the government's "knowing possession" standard and adopted the "use" standard.⁸⁴ In doing so, the Ninth Circuit focused on the defendant's use of material non-public information as a necessary fact to show scienter (This is different than the *Adler* court which focused on the defendant's use of such information as a necessary fact to show a breach of fiduciary duty). The court reasoned:

[I]f the insider merely possesses and does not use [the information], the two parties are trading on a level playing field . . . both individuals are 'making their decisions on the basis of incomplete information.' It is the insider's use, not his possession, that gives rise to an

79. *Id.* at 1344.

80. *Id.* at 1332-36.

81. *Id.*

82. *See Id.* at 1337 ("[W]hen an insider trades while in possession of material nonpublic information, a strong inference arises that such information was used by the insider in trading.").

83. 155 F.3d 1051.

84. *Id.* at 1066-69.

informational advantage and the requisite intent to defraud.⁸⁵

In contrast to the Eleventh Circuit, the Ninth Circuit declined to find that an evidentiary presumption exists that an insider uses material non-public information when he is in possession of such information and then trades.⁸⁶

The Second Circuit Court of Appeals came to a contrary decision in *United States v. Teicher*,⁸⁷ in which the court affirmed the convictions of tippee-arbitrageurs⁸⁸ who traded after obtaining misappropriated information about unannounced tender offers from the associate of a law firm. Although the Second Circuit accepted the government's argument that "knowing possession" of undisclosed material information is sufficient to prove an insider trading claim, the court's conclusion is largely dictum because the facts of the case showed actual use of the misappropriated information. Indeed, the court found that it was "unnecessary to determine whether proof of securities fraud requires a causal connection" in light of the evidence presented.⁸⁹

In August 2000, the SEC implemented a new rule addressing this issue.⁹⁰ The SEC's new Rule 10b5-1 follows *Teicher*⁹¹ and adopts the "possession" standard, and provides that, for purposes of insider trading, a person trades on the basis of material nonpublic information if a trader is "aware" of the material nonpublic information when making the purchase or sale.⁹²

The rule creates affirmative defenses where it is clear that the information is not a factor in the decision to trade. Rule 10(b)(5)-1(c)(1) provides that a person's trade is not made on the basis of material, non-public information if the person can demonstrate that, prior to becoming aware of that information, the person made arrangements to trade pursuant to a pre-existing *contract*,

85. *Smith*, 155 F.3d at 1068.

86. *Compare* *United States v. Smith*, 155 F.3d 1051 (9th Cir. 1988) *with* *SEC v. Adler*, 137 F.3d 1325 (11th Cir. 1998).

87. 987 F.2d 112 (2d Cir. 1993).

88. Arbitrage entails trading in securities in companies that are subject of changes in corporate control in order to take advantage of fluctuations in the price of these securities. *Id.* at 114.

89. *Id.* at 119.

90. Selective Disclosure and Insider Trading, 17 C.F.R. pts. 240, 243, and 249 (2000).

91. 987 F.2d 112.

92. 17 C.F.R. pts. 240, 243 and 249.

instruction or *written plan*.⁹³ In order for these affirmative defenses to be available, the contract, instruction or plan must specify the *amount* of securities to be purchased or sold, the *price* at which the securities are to be purchased or sold, and the *date* on which the transaction is to occur.⁹⁴

The other affirmative defense is available only to entities. Rule 10(b)(5)-1(c)(2) provides that an entity's trade is not made on the basis of material, non-public information if the entity can demonstrate that the person making the trade for the entity was not aware of the information and the entity had established "reasonable policies and procedures to ensure that the persons making the buy or sell decisions for it would not violate the laws prohibiting trading on the basis of material non-public information."⁹⁵

The SEC has recently published a Telephone Interpretations Manual with frequently asked questions and answers about this new rule.⁹⁶

III. THE MORALITY OF INSIDER TRADING.

The SEC has long targeted insider trading as a top enforcement priority. One reason for this focus is the belief that insider trading destroys the integrity of the capital markets.

There is, however, a contrarian view, that insider trading does not have a significant, adverse market impact. The contrary position is that in light of the average trading volume, insider trading has no discernible impact on other investors.⁹⁷ Moreover, the argument is made, insider trading performs a useful function by preparing the market and getting the market started in the proper direction before the information is publicly announced.⁹⁸ Otherwise, major announcements will cause wide price fluctuations that not only disrupt an orderly market but will cause more injury to outside investors than would the insider trading.⁹⁹

93. *Id.* (emphasis in original).

94. *Id.* (emphasis in original).

95. *Id.*

96. *Manual of Publicly Available Telephone Interpretations* at <http://www.sec.gov/interp/telephone.shtml> (last modified July 18, 2001).

97. H. MANNE, *INSIDER TRADING AND THE STOCK MARKET* (1966); see F. EASTERBROOK & D. FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 251 (1991).

98. EASTERBROOK & FISCHEL, *supra* note 97, at 251.

99. *Id.*

Of course the morality of insider trading does not depend on the market consequences of the trades but rather on the moral quality of the actions. Indeed, it has been questioned whether insider trading should be prohibited, and if so, why: "While its answer requires more than a response of, 'Yes, because the practice is unfair,' courts, commentators, and the SEC alike have all had difficulty identifying what harms actually arise from trades based on material nonpublic information."¹⁰⁰

There would appear to be at least two legitimate moral objections to insider trading. First, there is a concern about fairness - that insider trading provides an unfair information advantage. As an American Bar Association Task Force concluded:

In our society, we traditionally abhor those who refuse to play by the rules, that is, the cheaters and the sneaks. A spitball pitcher, or a card shark with an ace up his sleeve, may win the game but not our respect. And if we know such a person is in the game, chances are we won't play. These common sense observations suggest that two of the traditional bases for prohibitions against insider trading are still sound: the 'fair play' and 'integrity of the markets' arguments.¹⁰¹

Second, there is a concern about the use of information obtained in breach of one's fiduciary duty. The wrong is the breach of the fiduciary duty - usually the taking of information provided for legitimate corporate purposes - and the use of that information in a secret and deceptive manner for another purpose - namely, the pecuniary benefit of the person breaching the fiduciary duty.¹⁰²

100. Joseph J. Humke, Comment, *The Misappropriation Theory of Insider Trading: Outside The Lines of Section 10(b)*, 80 MARQ. L. REV. 819, 851 (1997).

101. Committee on Federal Regulation of Securities, *Report of the Task Force on Regulation of Insider Trading*, 41 BUS. LAW 223, 227 (1985).

102. See *In re Cady, Roberts & Co.*, 40 SEC 907, 917-18 (1961). Indeed, in *Cady, Roberts & Co.*, the SEC focused on the existence of a relationship providing access to inside information intended for a corporate purpose, and the inherent unfairness when a corporate insider takes unfair advantage of such information knowing it is unavailable to those with whom he is dealing. *Id.*

IV. DEFENDING INSIDER TRADING CLAIMS.

A. *Reliance on Counsel.*

An insider who consults with and relies on the advice of legal counsel prior to engaging in a trade may use those circumstances to demonstrate good faith and the lack of scienter. Common sense dictates that a person who consults with experienced securities counsel in advance of a trade, explains the relevant background, and follows counsel's advice, is acting prudently and without fraudulent intent.

For example, in *In re Digi International, Inc. Securities Litigation*,¹⁰³ the Eighth Circuit Court of Appeals affirmed a district court order granting defendants summary judgment in a class action alleging securities fraud. The appellate court found that "no reasonable jury could find the necessary element of scienter," reasoning, "[t]he undisputable fact that the Defendants were in consultations with their outside accountants and legal counsel during the period in question is in itself evidence which tends to negate a finding of scienter."¹⁰⁴

Courts have carefully distinguished between criminal and civil cases in mapping out the contours of this defense. Thus, although in a criminal case, good faith reliance on the counsel may rebut a showing of intent,¹⁰⁵ in a civil case, reliance on counsel is "not a complete defense, but only one factor for consideration."¹⁰⁶

To rely on this defense, a defendant must prove that he

- (1) made complete disclosure to counsel;
- (2) sought advice as to the legality of his conduct;
- (3) received advice that his conduct was legal; and
- (4) relied on that advice in good faith.¹⁰⁷

Merely talking with counsel is not enough. For example, in *Enterprises Solutions*, the CEO of a public company failed to disclose in a registration statement that a prior company he managed had filed for bankruptcy.¹⁰⁸ He admitted that fact was material, but

103. 14 Fed. Appx. 714, 2001 WL 753869 (8th Cir. July 5, 2001).

104. *Id.* at 718 (quoting *In re Digi Int'l Inc. Sec. Litig.*, No. 97-5, slip op. at 15 n.7 (D. Minn. Aug. 17, 2000) (modification in original)).

105. *United States v. Evangelista*, 122 F.3d 112, 117 (2d Cir. 1997).

106. *Markowski v. SEC*, 34 F.3d 99, 105 (2d Cir. 1994).

107. *SEC v. Enters. Solutions, Inc.*, 142 F. Supp. 2d 561, 576 (S.D.N.Y. 2001) (citing *Markowski*, 34 F.3d at 105).

108. *Id.* at 571.

contended he disclosed that fact to in-house counsel, and relied on them to include that information in the registration statement.¹⁰⁹ The court rejected the reliance on counsel defense here, reasoning that the defense requires “more than simply supplying counsel with information.”¹¹⁰ The court determined that corporate officers have an independent duty to insure that material information is disclosed, and that “[c]ompliance with federal securities laws cannot be avoided by simply retaining outside counsel to prepare required documents.”¹¹¹ Presumably, courts would come to the same conclusion in an insider trading case - mere consultation with counsel would not provide a defense.

Consultation with counsel in advance of a trade is no panacea. Certainly if counsel provides an unequivocal “green light” to client contemplating a trade, the client may well be able to rely on such advice to show good faith and disprove alleged intent to defraud. But experience suggests that those circumstances are rare. Prudent counsel in many cases may need to alert clients to the risk that trading may result in insider trading liability, depending upon a laundry list of circumstances, or suggest that the conservative advice is to abstain from the contemplated trades altogether. Presumably, a lawyer who fails to do so would risk exposure to malpractice liability if these qualifications and risks were not provided. Of course, if a client subsequently attempts to rely on the prior advice of counsel as a defense to insider trading claims, the attorney-client privilege would be waived, and all the qualifications or risks addressed by counsel could be used against the client, and in a devastating manner.

It is not even entirely clear whether the advice of counsel to engage in the trade - in the event of a subsequent insider trading prosecution - would remain privileged and confidential regardless of whether the good faith defense is raised.

In sum, the defense of reliance on counsel may be a meritorious defense to insider trading liability. Unfortunately for persons accused of insider trading, as a practical matter the defense is rarely available.

109. *Id.* at 576.

110. *Id.* at 571.

111. *Id.*

B. Pre-existing Plans, Contracts or Instructions.

See discussion above.

C. Adherence to Company Plans or Policies.

It is certainly indicative of good faith if an individual openly and deliberately follows an employer's insider trading policies. The 1988 Insider Trading and Securities Fraud Enforcement Act (ITSFEA) requires registered brokers, dealers, and investment advisors to "establish, maintain, and enforce written policies and procedures reasonably designed" to prevent insider trading by their employees.¹¹² While other employers are not required to maintain these written policies, they also face increased exposure from the SEC and private litigants. The new law broadens control person liability, increasing the economic incentives for such persons to supervise their employees vigorously.

The SEC has informally suggested that employers, especially law firms and public companies, adopt appropriate procedures to prevent unlawful insider trading.

Several provisions of ITSFEA are of special concern to employees: (1) the SEC can seek civil penalties from an employer whose personnel are guilty of illegal insider trading if the employee was reckless; and (2) if an employer failed to take preventive measures, although otherwise unknowing and innocent, it may be found reckless.

As an example, a typical insider trading policy may include the following provisions:

1. Prohibit buying or selling of client securities without authorization.
2. Prohibit buying or selling of securities on a restricted list (which may include some non-clients) without authorization.
3. Ban the buying or selling of options based upon client securities or restricted list securities.
4. Ban short sales of client securities or restricted list securities.
5. Require periodic reporting of purchases and sales.

If an employee follows an employer's insider trading rules, this should be one factor showing good faith.

112. Insider Trading & Securities Fraud Enforcement Act of 1988, Pub. L. No. 100-704, 102 Stat. 4677, 4680.

D. Proving Conduct was Legitimate - Rebutting the Circumstantial Evidence Case.

Most insider trading cases are based on circumstantial rather than direct evidence, especially with regard to the trader's intent to defraud. It is the nature of insider trading that there are rarely witnesses with first-hand knowledge available, much less writings that precisely relate what happened and why. Also, persons deliberately engaging in illegal insider trading often take some steps to conceal their activities before and after the trades. Insider trading cases are frequently based entirely on circumstantial evidence because:

[T]here are generally two people who can provide direct evidence that insider trading has occurred — the source of the information and the trader. It is very rare for one of these two persons to admit that they have engaged in insider trading. Most cases are based largely on circumstantial evidence.¹¹³

Courts, recognizing this practical reality, are hospitable to circumstantial cases. It is difficult to obtain dismissal on the pleadings or summary judgment in insider trading cases because of this hospitable environment for circumstantial claims, and the fact-bound nature of the key issues of materiality, the non-public nature of the information and intent. Accordingly, persons defending against insider trading claims frequently face the decision of settling the claims, or litigating the cases at trial.

*United States v. Larrabee*¹¹⁴ is a good recent example of the circumstantial evidence case against a legal professional. Larrabee was employed in the business office of a Boston law firm. He was responsible for selecting the stockbrokers who placed securities trades for the trust accounts managed by the firm. Larrabee developed a personal and financial relationship with D'Angelo, a stock broker at PaineWebber, Inc.¹¹⁵

In December 1995, the law firm represented Bank of Boston in a merger transaction with BayBanks. Larrabee had daily contact with John Brown, one of the firm's lawyers involved in the transaction. On December 12, 1995, Larabee called D'Angelo and

113. *Elysian Fed. Sav. Bank v. First Interregional Equity Corp.*, 713 F. Supp. 737, 744 (D.N.J. 1989) (quoting H.R. REP. NO. 100-910, at 15 (1988)).

114. 240 F.3d 18 (1st Cir. 2001).

115. *Id.* at 19.

they spoke for about one minute. Thereafter, D'Angelo entered orders to buy 11,000 shares of BayBanks stock priced at \$85 per share for his own account, for his family members' account and his girlfriend's account. After the market closed that day, Bank of Boston and BayBanks announced their merger. The next day, BayBank's stock price increased by \$8 per share before the market opened. D'Angelo immediately placed orders to sell the stock he had purchased the evening before, resulting in profits of about \$86,750.¹¹⁶

A criminal insider trading prosecution ensued against Larrabee and D'Angelo, and both men were convicted on nine counts of securities fraud. On appeal, the court found that there was compelling evidence to support Larrabee's conviction, including these factors:

1. Access to information;
2. Relationship between the tipper and tippee;
3. Timing of contact between the tipper and tippee;
4. Timing of the trades;
5. Pattern of the trades; and
6. Attempts to conceal either the trades or the relationship between the tipper and the tippee.¹¹⁷

These are similar to the circumstantial factors consistently relied upon by courts in denying summary judgment motions and upholding liability determinations.

V. CONCLUSION.

As a very practical matter, defending legal and financial advisors in these cases requires a concerted effort to prove the trader's conduct was legitimate, and, in Emily Dickinson's language, to provide a legitimate slant on these same circumstantial factors. Clear timelines, legitimate business and personal reasons for the transactions, other sources of information and other reasons for the transaction, prior investment patterns, conformance with professional and industry practices, conformance with statutory and company policies, consultation with professionals, and the absence of concealment are helpful elements of such a defense.

116. *Id.* at 20.

117. *Id.* at 21-22.