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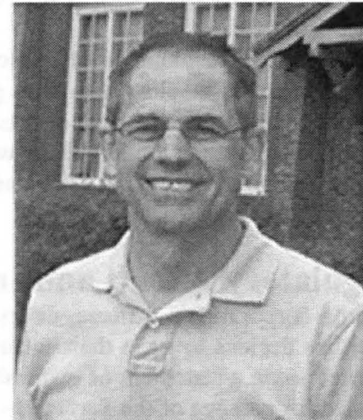

Insider Trading in the United States

James H. Thompson, Associate Professor of Accounting

Abstract

Insider trading is the buying or selling of a corporation's stock or other securities by an employee who has the potential to access non-public information about the company. Although most individuals associate insider trading with illegal activity, a majority of the trades are done legally. Illegal insider trading refers generally to buying or selling a security, in breach of a fiduciary duty or other relationship of trust and confidence, while in possession of material, nonpublic information about the security. This paper discusses disclosures, regulatory efforts, impact on investor confidence, relationship to ethics, and history of major court decisions regarding insider trading in the United States.

Key Words: Insider trading, fiduciary responsibility, ethics

Insider Trading in the United States

In general terms, insider trading is the buying or selling of a corporation's stock or other securities by an employee who has the potential to access non-public information about the company. Although most individuals associate insider trading with illegal activity, a majority of the trades are done legally. According to the United States Securities and Exchange Commission (SEC), "The legal version is when corporate insiders—officers, directors, and employees—buy and sell stock in their own companies" (SEC 2001).

Illegal insider trading refers generally to buying or selling a security, in breach of a fiduciary duty or other relationship of trust and confidence, while in possession of material, nonpublic information about the security. Insider trading violations may also include "tipping" such information, securities trading by the person "tipped," and securities trading by those who misappropriate such information" (SEC 2001). A fiduciary is someone

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confidence. In other words, if an individual has been entrusted with the management of assets (as is the case of managers of publicly traded companies), this individual has a fiduciary duty to the owner of those assets (in the case of the publicly traded company, the owners are the investors). Insider trading rules prohibit individuals who have material, price-sensitive information from trading (Reichman 1993). This paper discusses disclosures, regulatory efforts, the impact on investor confidence, the relationship of ethics, and the history of major court decisions regarding insider trading in the United States.

Company policies

Because of the SEC's stance on insider trading and the legal ramifications associated with illegal insider trading, most companies have an insider trading policy. A number of companies post their policies posted on company websites, often included with their code of ethics.

Although disclosure of insider trading helps prevent illegal insider trading, potential fines and penalties that are enforced by the SEC probably have a greater effect. The SEC may levy fines of up to $1,000,000 and a term of imprisonment of up to ten years. In addition, the SEC can recover the profits gained or losses avoided through volatile trading, plus a penalty of up to three times the illicit windfall or loss avoided, and an order permanently enjoining violators from such activities. Also, "Violators may be sued by investors seeking to recover damages for insider trading violations." (SEI 2004)

Because of the great number of employees, company insiders, and stockholders trading securities, it is important for companies to be clear with their policies towards insider trading. Likewise, the SEC must be clear with its rules and regulations. Despite efforts of the SEC and publicly traded companies to provide clarity, the ultimate responsibility rests with individuals who are expected to act ethically and follow the rules that put are in place to protect investors. Appendix A contains the examples of corporate insider trading policies provided by Boeing, Weyerhaeuser, and Costco.

Regulatory Efforts and Insider Trading

When a corporation's officers, directors, or anyone who owns more than 10 percent of the company's equity securities decides to trade their securities, the transaction must be reported to the SEC. Such transactions are reported using a statement of ownership since the passage of the Securities and Exchange Act of 1934 and was updated for passage of the Sarbanes-Oxley Act of 2002. The initial filing is done using Form 3 and is required when an issuer "…is registering equity securities for the first time under Section 12 of the Exchange Act…" (SEC 2008). When ownership changes, Form 4is filed, and Form 5 is filed when transactions are reported late or have been deferred. Under SEC requirements, these forms must be submitted electronically to the SEC and also must be posted on the company's website no later than one business day after filing with the SEC. The main purpose of the filing requirements is to keep investors informed of any large transactions that may have a major impact on the company or the company's securities.

Congress' primary efforts to regulate insider trading are contained in the Securities Act of 1933 and the Securities Exchange Act of 1934 (Robertson 1998). Under Franklin D. Roosevelt's leadership and in response to the market crash of 1929, Congress implemented these Acts. Mandated insider trading disclosure requirement originated with the Securities Exchange Act of 1934. Section 16(a) of the 1934 Act requires disclosure of all insider trades, and section 16(b) prohibits "short swing profits" (Bris 2005). "Short swing" profits are profits realized in a period of less than six months (Robertson 1998).

Congress also passed the Insider Trading and Securities Fraud Enforcement Act of 1988 (ITFSA) as reaction to the scandals of the mid-1980s that exposed complex insider trading activity (Reichman 1993). In addition, on August 27, 2002, the SEC adopted new rules and amendments to Section 16 of the Exchange Act, implementing the provisions of the Sarbanes-Oxley act that accelerated the deadline for filing most insider ownership reports (SEC 2008).

Insider trading and investor confidence

Using illegal insider information involves the unlawful use of material, nonpublic information (Reichman 1993) which places the transacting parties at an uneven level. According to Arturo Bris (2005) from the Yale School of Management, "trading based on privileged access to information can demoralize investors and destabilize investment. It has utterly no place in any fair-minded, law-abiding economy." Thus to keep investors in a fair trading field, it is necessary to have rules that regulate the information used to make decisions on the timing for securities trading. The objective of the rules on insider trading is to reduce the advantage of being an "insider" so that the outsiders, that is the market investors, participate in trading stock without the thought or the feeling that the market is being manipulated against them (Reichman 1993).

One of the main goals of the SEC through its regulations has been to protect investor confidence. In fact, the SEC has argued successfully that insider trading constitutes fraud committed by the insider on the non-insider. If such fraud was allowed, investors would be aware that (the fraud) occurred but would have no way to know when an insider was the trading partner in a given transaction (because the trades are anonymous). Therefore, they would be discouraged from investing because they would know that they could not win against superior information. Thus, in order to shore up the confidence of average investors, they must be convinced that insiders are not permitted to make such trades (Bris 2005).

The confidence of the investors is based on the belief that they are protected by a regulatory system that ensures the integrity of capital markets above and beyond investors' own ability to monitor them (Comeau 2006). In other words, investor confidence is based on trust. Trust can be defined in this context as the expectation by the investor of ethically justifiable behavior or morally correct decisions and actions based upon ethical principles of analysis on the part of the management of the company in which he or she is investing (Hosmer 1995).

Insider trading and ethics

There are authors, such as Robert W. McGee (2007, 2009) a professor from Barry University, who defend the use of insider information to trade stock as ethical. According to McGee, utilitarianism can be used to justify the use of insider information. He contends that, from a utilitarian point of view, the use of insider information will lead to a positive-sum game because the gains of using that information exceed the losses. Among the gains that he suggests is the fact that insider information can be compared to other strategic information that the company owns; thus the owners of that information can use that knowledge to make a profit.

According to McGee, insider information can be compared to other assets of the company that would give a competitive advantage to the owner. Thus, management can use this information to make a profit. For example, inside information is a competitive advantage for the company in some fields such as in R&D (Coff and Lee 2003). However, the same concept may not be appropriate to trading of ownership securities (Boyle 1992),

McGee fails to mention that, even if management executives own stock of the public company, they are not the sole owners of the company and of the information. Therefore, management executives are not the only owners of this knowledge even if they have the information in their hands. Management cannot use the information ethically if this data has not been shared with other owners and/or investors who are planning to invest in that company. To take advantage of insider information knowing that it is unavailable to the non-insider party is intrinsically unfair to the non-insider trading party (Bris 2005). Furthermore, to trade stock using insider information puts management at an upper level of knowledge and gives management an unfair advantage when trading stock.

Court decisions

Much of the development of insider trading law has resulted from court decisions. In 1909, the Supreme Court ruled in *Strong v. Repide* that a director of a corporation cannot gain from share purchases or sales if his future actions will have a positive or negative impact on the share price. The case reads "[the director] should disclose upon whose action the value of the shares depends and cannot avail of his knowledge of what his own action will be to acquire shares from those whom he intentionally keeps in ignorance of his expected action and the resulting value of the shares." Ordinarily, directors have no fiduciary duty to disclose this knowledge to shareholders, but it may exist in the case of stock trading by directors (Strong V. Repide, 213 U. S. 419 1909).

Almost sixty years later, the next great step toward insider trading transparency was announced by a court. In *SEC v. Texas Gulf Sulphur Co.* (1966), a federal circuit court affirmed that anyone in possession of inside information must either disclose the information or refrain from trading (Haddock, David D 2003).

In 1984, the Supreme Court of the United States ruled in the case of *Dirks v. SEC* that receivers of second-hand information are liable if they had reason to believe that the insider had breached a fiduciary duty in disclosing confidential information and the insider received any personal benefit from the disclosure. Although Dirks was found innocent, since he disclosed the information in order to expose a fraud rather than for personal gain, the case serves as a hallmark for future interpretations. The case also defines the concept of constructive insiders: lawyers, accountants, investment advisers, bankers, and anyone else who receives confidential information while providing services to a corporation. Constructive insiders can be charged with insider trading violations since they acquire the fiduciary duties to keep the information confidential.

Just two years later, in *United States v. Carpenter*, the U.S. Supreme Court unanimously upheld mail and wire fraud convictions for a defendant who received his information from a journalist rather than from the company itself. The journalist, R. Foster Winans, was also convicted on the grounds that he had misappropriated

information belonging to his employer, the Wall Street Journal. In that widely publicized case, Winans traded in advance of "Heard on the Street" columns appearing in the Journal (Cox 2006). The court ruled in *Carpenter*, "It is well established, as a general proposition, that a person who acquires special knowledge or information by virtue of a confidential or fiduciary relationship with another is not free to exploit that knowledge or information for his own personal benefit but must account to his principle for any profits derived therefrom."

In 1997 the U.S. Supreme Court adopted the misappropriation theory of insider trading in *United States v. O'Hagan*. O'Hagan was a partner in a law firm representing Grand Metropolitan. While the company was considering a tender offer for Pillsbury Co., O'Hagan used this inside information by buying call options on Pillsbury stock, resulting in personal profits of over $4 million. O'Hagan claimed that neither he nor his firm owed a fiduciary duty to Pillsbury, so he did not commit fraud by purchasing Pillsbury options. The Court rejected, however, O'Hagan's arguments and upheld his conviction. The "misappropriation theory" holds that a person commits fraud in connection with a securities transaction, and thereby violates 10(b) and Rule 10(b-5), when he uses confidential information for securities trading purposes, in breach of a duty. Under this theory, a fiduciary's undisclosed, self-serving use of a principal's information to purchase or sell securities, in breach of a duty of loyalty and confidentiality, defrauds the principal of the exclusive use of the information. In lieu of premising liability on a fiduciary relationship between company insider and purchaser or seller of the company's stock, the misappropriation theory premises liability on a fiduciary-turned-trader's deception of those who entrusted him with access to confidential information. The Court specifically recognized that: "A company's confidential information...qualifies as property to which the company has a right of exclusive use. The undisclosed misappropriation of such information, in violation of a fiduciary duty...constitutes fraud akin to embezzlement – the fraudulent appropriation to one's own use of the money or goods entrusted to one's care by another" (United States v. O'Hagan; 1997).

In 2000, the SEC enacted Rule 10(b5-1), which defined trading on the basis of inside information as any time a person trades while aware of material nonpublic information – so that it is no defense for one to say that he or she would have made the trade anyway. This rule also created an affirmative defense for pre-planned trades.

The most well-known case of insider trading occurred in 2003. The Securities and Exchange Commission investigated trading in the shares of ImClone Systems. This investigation resulted in a widely publicized criminal case and prison terms for media celebrity Martha Stewart. Stewart became embroiled in the scandal after it emerged that she sold about $230,000 in ImClone shares on December 27, 2001, just a day before the announcement of an unfavorable FDA decision. The day after her indictment, Stewart took out a full-page advertisement in *USA Today* and launched a website with an open letter of defense "to my friends and loyal supporters." She said, "I want you to know that I am innocent — and that I will fight to clear my name. The government's attempt to criminalize these actions makes no sense to me. I am confident I will be exonerated of these baseless charges." (CNN 2004). On March 5, 2004, Stewart was found guilty by a jury on four counts: conspiracy, obstruction of justice, and two counts of making false statements to a federal investigator. She was sentenced to five months in prison, five months of home confinement, and two years of probation for lying about a stock sale, conspiracy, and obstruction of justice

In May 2007, a bill entitled the "Stop Trading on Congressional Knowledge Act," or the "STOCK Act," was introduced. This bill holds congressional and federal employees liable for stock trades they made using information they gained through their jobs and also regulate analysts or "Political Intelligence" firms that research government activities. To the great joy of legislator's majority, the bill did not pass (Gross, Daniel 2007).

Conclusion

The rules and policies for insider trading are complex and cumbersome. This paper considers company policies, regulatory efforts, effect on investor confidence, ethics considerations, and court decisions to understand the implications for those engaged in insider trading. Considerable uncertainty regarding possible fines and imprisonment exist for those involved. Also, potential ramifications of insider trading rules are quite different for people with differing degrees of access to proprietary data. A "cookie cutter" approach for dealing with insider trading issues is not helpful to affected employees; rather, individual strategies for compliance with insider trading laws are needed, and legal counsel should be obtained. ■

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Appendix A

Insider Trading Policies

Insider Trading Weyco.pdf

Insider Trading Boeing.pdf

Insider Trading Costco.pdf