

Corporate Insider Trading : New Dimensions In Liability

by

Barbara Crutchfield George and Maria Boss
both of the California State University at Long Beach

INTRODUCTION

At first glance it may appear that the law which prohibits the use of material non-public information only applies to the technical "insider" (e.g., corporate directors and officers). However, the scope of the prohibition encompasses persons other than technical insiders. Because the statutory language in Section 10 (b)¹ is broad in scope, and for that matter never mentions directly or indirectly the term "insider trading," the United States Supreme Court will ultimately have to determine to whom the term "insider" can be applied. At the present time there is a conflict between the lower courts and the Securities and Exchange Commission ("SEC"), on the one hand and the U.S. Supreme Court, on the other, in the handling of insider trading cases: the lower courts and the SEC are expanding the scope of liability for insider trading, but this expansion has been rejected by the high court when it has been confronted with such expansion attempts.

In August, 1984, Congress passed the Insider Trading Sanctions Act which has increased the penalties for insider trading.² However, the Insider Trading Sanctions Act did not define insider trading but increased the civil and criminal penalties without setting forth with specificity the group against whom the penalties will apply. Thus the problem now is in the hands of the courts and, in particular, the U.S. Supreme Court.

The U.S. Supreme Court has taken an aggressive role in limiting the application of Section 10(b) and Rule 10b-5³ in a number of landmark cases in which the SEC was seeking to expand the interpretation of the statutory language. For example, in 1976 in Ernst and Ernst v. Hochfelder,⁴ the court refused in a private cause of action for damages to expand the prohibitions of Section 10b and Rule 10b-5 to include negligent conduct and limited liability to situations involving scienter (guilty knowledge). It affirmed this position in 1980 in Aaron v. Securities and Exchange Commission,⁵ where the court held that scienter was necessary as an element for violation of Section 10(b) and Rule 10b-5, again rejecting the argument of the SEC, which argued that differences in the plaintiff (the SEC rather than a private individual) and the nature of the relief (an injunction rather than damages) would justify a different result. Clearly, under Ernst and Aaron negligence without scienter will not afford a basis for liability.

After the seminal case of SEC. v. Texas Gulf Sulphur⁶ was decided in 1968, the SEC apparently was confident about the position of the U.S. Supreme Court regarding insiders (and their tippees) and began trying to establish the outer limits of the definition of "insiders". The agency accused an increasing number of external people of violating Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder. The SEC has tried to apply the rules to anyone merely possessing inside information, i.e., non-insiders with no direct relationship to the corporation. The SEC has made it clear that the preservation of equality of opportunity in stock transactions is paramount.

The SEC has recently charged that C. Foster Winans, a principal writer of the Wall Street Journal's "Heard on the Street" column, received payment for

giving information to others regarding the timing and contents of the newspaper articles.⁷ The articles affected the value of the stock in corporations covered in the feature. Thus, Winans, who had no direct or indirect relationship with the corporation, was the subject (along with his tippees) of SEC instigated lawsuits for both civil and criminal liability under Section 10(b) and Rule 10(b)5. This resulted in a criminal conviction in August, 1985, and a Consent Decree in October, 1985.

This case must progress through the federal appellate system to the U.S. Supreme Court. The U.S. Supreme Court has not upheld the SEC in its previous attempts at regulation in the widely publicized cases of Chiarella v. United States⁸ and Dirks v. SEC.⁹ In those cases, the SEC sought to impose liability for the use of nonpublic information on persons who had no connection with the corporation and, hence, no direct fiduciary relationship with the stockholders. How will the court react to this latest attempt of the SEC to expand the definition of insiders? Are the circumstances so different from the prior cases that a different result can be expected? It is the purpose of this paper to respond to these questions.

HISTORICAL DEVELOPMENT OF THE INSIDER TRADING LAWS

Insider trading is prohibited in two sections of the Securities Exchange Act of 1934, section 10(b) and section 16(b).¹⁰ The language of section 10(b) is broad in scope and generally prohibits the use of fraud or deceit in connection with the purchase and sale of securities. In 1942 the Securities and Exchange Commission promulgated Rule 10(b)5 in which it was declared unlawful for a stock trader to make untrue or inaccurate statements regarding stocks.

Section 16(b) deals exclusively with insiders, who are specifically defined as directors, officers, and persons who directly or indirectly own more than 10% of any class of any equity security registered with the SEC. The purpose of the section is to protect "outside" stockholders against short-swing speculations by insiders. It requires that the insider turn over to the company any profits realized from a purchase and sale of securities within a six month period. This legislative provision became significant when the United States Supreme Court in the Texas Gulf Sulphur case made it quite clear that the 16(b) definition of "insider" was not being applied in determining liability under Section 10(b), thus leaving the SEC free to widen the interpretation. Although Texas Gulf Sulphur involved only those who could be considered technically as insiders and their "tippees", the broad language used by the court gave the agency the leeway to begin trying to expand the definition of insider. It is interesting to note that "tippees" are outsiders who have been brought within the scope of Section 10(b) and Rule 10(b)5. They were specifically held liable in the Texas Gulf Sulphur case. This is the real connection and the basis upon which the SEC can argue that persons who have no direct relationship with a corporation can be held liable. The tippee is liable and is not allowed to hide behind the fact that there is no fiduciary relationship with the stockholders of the issuer and, hence, no duty to them. The differentiating factor between the classic tippee situation and the Chiarella and Dirks circumstances is that, in the former, the tippee obtained the information from an insider who at the very least was in a fiduciary relationship with the corporation. In the latter, the information was obtained from sources outside the fiduciary sphere of the corporation. Mr. Winans also did not receive his information from one who was in a fiduciary relationship with the corporation.

There are slight differences among the ways in which Dirks, Chiarella and Winans received the information. Chiarella "accidentally"¹¹ received the

information from material that he was printing for his employer and breached his duty to his employer. Dirks received the information from a tipper who had previously been with the corporation. Winans was a reporter who gathered his own information from various sources. However, as will be discussed below, it does not appear that these slight differences justify a different result in the Winans situation from the results in Chiarella and Dirks.

SEC AND FEDERAL COURT EXPANSION OF DEFINITION
AND U.S. SUPREME COURT RESPONSE

Chiarella v. United States

The Chiarella case¹² illustrates the conflict which has arisen between the approach of the SEC and the lower federal courts to insider trader regulation and the response which this approach has elicited from the United States Supreme Court. Mr. Chiarella was a financial printer who was able to discover confidential information about impending tender offers during the course of his employment. He used the information to obtain substantial profits for himself. The SEC argued that a duty to disclose arose from: (1) the existence of a relationship affording access to inside information intended to be available only for a corporate purpose and (2) the unfairness of allowing such a person to take advantage of that information by trading without disclosure. The United States Court of Appeals upheld Mr. Chiarella's criminal conviction at the district court level and accepted the SEC's argument, holding that even persons who are not corporate insiders who receive material nonpublic information may not use such information to trade in securities without incurring an affirmative duty to disclose.¹³

This approach of the SEC and the lower courts was rejected by the United States Supreme Court which held that the mere possession of nonpublic market information does not result in a duty to disclose. Rather the duty arises from a fiduciary relationship between the parties:

No duty could arise from petitioner's relationship with the sellers of the target company's securities, for petitioner had no prior dealings with them. He was not their agent, he was not a fiduciary, he was not a person in whom the sellers had placed their trust and confidence. He was in fact a complete stranger . . .¹⁴

The duty of outsiders such as Mr. Chiarella arises only if they profit from the use of information which they know is confidential and which they know or should have known came from a corporate insider. The outsider's duty arises as a participant in the insider's breach of fiduciary duty. In overturning Mr. Chiarella's criminal conviction, the United States Supreme Court thus limited outsider liability to traditional situations involving aiding and abetting fraudulent conduct. Note that Mr. Chiarella had already "disgorged" his profits in a consent decree entered with the SEC.

Dirks v. SEC.

The United States Supreme Court again rejected the position of the SEC and the lower courts in Dirks v. SEC.¹⁵ Mr. Dirks, a securities analyst with a New York brokerage firm, uncovered one of the largest corporate frauds in history when he learned from a former Equity Funding officer that the company had built its business on phony insurance policies. Although Mr. Dirks first disclosed the story to the Wall Street Journal and ultimately reported the fraud to the SEC, he also informed clients who were institutional investors;

one group of clients was able to dump \$17 million of their holdings before the story was printed and the investigation became public. The SEC censured Mr. Dirks, charging that he had violated the antifraud provisions of Section 10(b). The SEC argued that Mr. Dirks had breached a fiduciary obligation to Equity Funding's shareholders by making inside nonpublic information about Equity Funding's fraudulent activities known to his clients before making it public; this obligation arose when he received the information from the former officer of Equity Funding. As in the Chiarella decision, the lower federal courts agreed with the SEC position, holding that the obligation of corporate fiduciaries passes to any person to whom information has been disclosed before it is disseminated to the public.

Again, the United States Supreme Court overturned the decisions of the lower courts and disagreed with the SEC contentions, holding that the duty to disclose arises only when a fiduciary relationship exists. A fiduciary relationship does not exist simply because one possesses nonpublic market information. Because the typical tippee has no relationship with the corporation or its shareholders, the tippee's liability is derivative from the duty of insiders such as corporate officers, directors, and majority shareholders.

[A] tippee assumes a fiduciary duty to the shareholders of a corporation to trade on material non-public information only when the insider has breached his fiduciary duty to the shareholders by disclosing the information to the tippee and the tippee knows or should know that there has been a breach.¹⁶

The court emphasized that whether there is a breach of duty by the insider depends on the insider's purpose in making the disclosure. Will some personal gain result from the disclosure. If there is no personal gain by the insider, there can be no derivative breach by the tippee.

The Dirks court also recognized the limited situation in which certain outsiders, such as accountants and lawyers, who receive corporate information legitimately may become fiduciaries under the doctrine of "constructive insider."¹⁷ The fiduciary duty of such persons does not arise because they have acquired nonpublic corporate information, but because they have entered into a special confidential relationship in the conduct of the business and are given access to information solely for corporate purposes. If such a person breaches his fiduciary relationship, he may be more properly treated as a tipper rather than a tippee. In order for such a duty to be imposed, the corporation must expect the outsider to keep the disclosed nonpublic information confidential, and the relationship must at least imply such a duty.

The Winans Case

Considerable attention has been given recently to the situation involving R. Foster Winans, a reporter who was fired by the Wall Street Journal for leaking market-sensitive information in advance of publication of his widely-read column, "Heard on the Street." Although most of the information involved material which Mr. Winans wrote himself, some involved information from other columnists who wrote articles for the Wall Street Journal.

It is important to note that the SEC based some of its allegations of securities violations on Mr. Winans misappropriation of confidential information from his newspaper. Although the U.S. Supreme Court has not yet held that misappropriation will result in a violation of Section 10(b), it may do so at some time in the future. In his dissent in Chiarella, Chief Justice Warren Burger stated:

I would read Section 10b-5 to encompass and build on this principle; to mean that a person who has misappropriated nonpublic information has an absolute duty to disclose that information or refrain from trading. The language of Section 10(b) and of Rule 10b-5 plainly support such a reading. By their terms, these provisions reach any person engaged in any fraudulent scheme.¹⁸

Justice Blackmun, joined by Justice Marshall, indicated support for this view in his dissenting opinion, as did Justice Brennan in his concurring opinion. Justice Brennan agreed with the majority that a duty to disclose does not arise from the mere possession of nonpublic market information but would not require a fiduciary relationship between buyer and seller to create a duty to disclose:

[A] person violates Section 10(b) whenever he improperly obtains or converts to his own benefit nonpublic information which he then uses in connection with the purchase or sale of securities.¹⁹

On August 6, 1985 Mr. Winans was sentenced to 18 months in prison and fined \$5,000 in New York Federal District Court. He was also ordered to work for 400 hours in community service during a period of five years probation.²⁰ Federal Judge Charles E. Stewart Jr. found Mr. Winans guilty on 59 counts²¹ of an indictment charging securities, mail and wire fraud and conspiracy. Mr. Winans' attorney has stated that he will appeal. Mr. Winans settled the civil charges against him by signing a consent decree with the SEC on October 22, 1985 promising not to violate the securities laws and agreeing to repay \$4,503, representing his profit from trading on the information.²² The SEC had charged that Mr. Winans had conspired with his roommate and with stockbrokers from Kidder, Peabody Co. to profit from the advance knowledge.

It is difficult to believe that the U.S. Supreme Court would affirm Mr. Winans' criminal conviction in light of its holdings in Chiarella and Dirks, assuming that the Court of Appeals affirms the District Court's decision. None of the requirements of Chiarella and Dirks are met. The court stated in Chiarella that the mere possession of nonpublic market information does not result in a duty to disclose. Mr. Winans only released advance information about nonpublic market information which he had obtained through rumors and from colleagues. Although this information could ultimately affect the price of the stock when it was published in the newspaper, Mr. Winans' possession of such information did not result in a duty to disclose under the Chiarella standard. Neither is there derivative liability under the Dirks analysis; the information was not obtained from an insider who breached his or her fiduciary duty for personal gain. He did not receive the information legitimately while performing some function for a corporation. Moreover, the Dirks court noted:

Imposing a duty to disclose or abstain solely because a person knowingly receives material nonpublic information from an insider and trades on it could have an inhibiting effect on market analysts, which the SEC itself recognizes as necessary to the preservation of a healthy market.²³

CONCLUSION

The Winans' conviction highlights the present inconsistency in SEC

enforcement of Section 10(b) and Rule 10b-5 despite the position of the U.S. Supreme Court. Even if the misappropriation theory is eventually accepted by the high court, there would still be ambiguity regarding the activity required to constitute a "misappropriation," particularly in view of the fact that scienter is required. Clearly, Congress has chosen not to respond to the problems arising from the conflict between the approach taken by the SEC and the lower courts, and the approach taken by the U.S. Supreme Court. It had such an opportunity in 1984 when drafting the Insider Trading Sanctions Act. In fact, Senator D'Amato of New York made an attempt to incorporate a definition in the Act. The SEC was vocal in its opposition to including a specific definition, stating that it did not want to limit the discretion and enforcement authority of the courts. Although the U.S. Supreme Court will have to resolve the conflicting approaches of its members regarding the applicability of the misappropriation theory, the burden rests upon it to ultimately resolve anomalies such as the Wlnans conviction. It would appear that it will have no choice except to overturn the conviction if it follows the precedents set in the Chiarella and Dirks decisions.

ENDNOTES

1. Securities Exchange Act of 1934 Section 10(b), 15 U.S.C. Section 78j(b) (1982) provides:

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 use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

2. Insider Trading Sanctions Act of 1984; Pub. L. No. 98-376, 98 Stat. 1264 (1984). The act imposes civil liability of treble damages instead of simple disgorgement of profits and an increase in the criminal fines for willful violations from \$10,000 per violation to \$100,000 per violation, or imprisonment for not more than five years, or both. In addition, provision is made for injunctive relief.

3. Securities Exchange Commission Rule 10b-5, 17 CFR 240.10b-5 (1982) provides: 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 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.

4. 425 U.S. 185 (1976).
5. 446 U.S. 680 (1980).
6. 401 F. 2d 833 (2nd Cir. 1968), cert. denied 404 U.S. 1005 (1971).
7. U.S. v. Brandt, Fed. Sec. L. Rep. (CCH) 99483.
8. 445 U.S. 222 (1980).
9. 463 U.S. 646 (1983).
10. 15 U.S.C. 78 (1976).
11. See SEC Rule 10b-5: Tippee Liability Revisited, 22/3 Am. Bus. L. J. 385.
12. Chiarella v. United States, 445 U.S. 222 (1980).
13. Id. at 236.
14. Id. at 232-33.
15. 463 U.S. 646 (1983). See also Dirks v. Securities and Exchange Commission: An Outsider's Guide to Insider Trading Liability Under Rule 10b-5, 22 Am. Bus. L.J. 569.
16. Id. at 655 n. 14.
17. Id.
18. Chiarella v. United States, 445 U.S. 222 (1980).
19. Id. at 239.
20. Winans Gets 18-Month Term in Trading Case, The Wall Street Journal, August 7, 1985.
21. Id.
22. Winans Gets 18-Month Term in Trading Case, The Wall Street Journal, August 7, 1985.
23. Dirks v. Securities and Exchange Commission, 463 U.S. 646, 658 (1983).