**INSIDER TRADING**

**a)Who may be hurt by insider trading:**

1)Target shareholders--they sell too early;

2)Other arbitrageurs--they lose a portion of the gain that they make from honest effort

3)Other issuers--they lose confidence in the stock market

4)The acquiring company--insider trading drives up their cost of acquisition, since the target may adopt defensive measures otherwise not in place.

**b)Possible Sources of Liability**:

1)Common Law;

2)10b-5 traditional;

3)10b-5 misappropriation theory (O’Hagan);

4)Mail or wire fraud;

5)14e-3;

6)Statutory liability under 16(b)--insiders are forced to give their profits to the corp, if the y buy and sell securities within a 6-month period **regardless** of whether they are using insider info. (Need to know 2, 3, 6)

**c)O’Hagan**--insider trading violation where a partner in law firm took info rom his firm regarding the firm’s client’s plans for acquisition of Pillsbury and used that info to buy shares in Pillsbury

**d)Penalties For Insider Trading**--ITSA (Insider Trading Sanctions Act)--3 measures:

1)Out-of-pocket measure--if a sh buys a share for $10, while in fact it costs $9, his out-of-pocket expense is $1.

2)Causation-in-fact--because an insider engaged in insider trading, it caused a loss

3)Disgorgement--we look at D’s profit. ITSA measures the damage to sh by the amount of profit that D received from the transaction.

2)SEC civil penalties--treble damages; SEC may seek penalty capped by three times profit gained or loss avoided.

**A.COMMON LAW**--under the majority rule, there was **no** duty to disclose to the shs inside info affecting the value of shares. Therefore, the protection of investors was very weak.

**a)For lability to exist there should be**:

1)At least fraud or deceit upon purchasers;

2)May also be a device or scheme;

3)May also be an implied misrepresentation.

**b)Two Elements (relationship and unfairness):**

1)Relationship--existence of a relationship giving access, directly or indirectly, to information intended to be available for a corporate purpose and no other.

I)Insiders include at least officers, dirs, controlling shs (In re Cady Roberts)

ii)Persons charged with confidentiality by contractual or fiduciary relationship

2)Unfairness--inherent unfairness that results when a party takes advantage of such information knowing it is unavailable to person with whom he is dealing.

**B.SECURITIES EXCHANGE ACT OF 1934--IN GENERAL**--the act superseded common law. Section 12 of the Act requires **registration** of any security traded on a national exchange, or any equity security (held by 500 or more persons) of a corp with assets exceeding $5 million.

**C.SECTION 10(B) AND RULE 10B-5**--section 10(b) prohibits any manipulation or deception in the purchase or sale of any security, whether or not it’s registered. Rule 10b-5 prohibits the use of the mails or other instrumentality of interstate commerce to defraud, misrepresent, or omit a material fact in connection with a purchase or sale of **any** security.

**1.COVERED CONDUCT**--rule 10b-5 applies to **nondisclosure** by dirs or officers, as well as to **misrepresentations**. It applies not only to insider trading but also to **any** person who makes a misrepresentation in connection with a purchase or sale of stock.

**2.COVERED SECURITIES**--rule 10b-5 applies to the purchase or sale of **any** security, registered or unregistered. a jurisdictional limitation requires that the violation must involve the use of some **instrumentality of interstate commerce**.

**3.WHO CAN BRING SUIT UNDER 10B-5**--private plaintiffs and the SEC. Private plaintiffs must be either purchasers or sellers of security.

**4.MATERIALITY**--for rule 10b-5 to apply, the information misrepresented or omitted must be material (i.e., a reasonable sh would consider it important in deciding whether to buy or to sell).

**5.FAULT REQUIRED (SCIENTER)**--a defendant is not liable under rule 10b-5 if he was without fault or merely negligent. The scienter requirement is satisfied by **recklessness** or an intent to deceive, mislead, or convey a false impression. Scienter is also required for injunctive relief.

**a)Recklessness Defined**:

1)D knew the hazard and proceeded nonetheless (subjective test);

2)D proceeded despite what a reasonable person would perceive (objective test);

**b)Recklessness Under PSLRA**:

1)Knowing conduct-- yields jointly and severally liable;

2)Non-knowing conduct (e.g., recklessness)--yields fair share (proportionate liability), found in accordance with special interrogatories.

**6.CAUSATION AND RELIANCE**--a plaintiff must prove that violation caused a loss (i.e., he must establish reliance on the wrongful statement or omission). However, in **omission** cases, there is a rebuttable presumption of reliance once materiality is established.

**a)Fraud On The Market**--where securities are traded on a well-developed market (rather than in a face-to-face transaction), reliance on a **misrepresentation** may be shown by alleging reliance on the integrity of the market.

**b)Face-to-Face Misrepresentations**--a plaintiff can show actual reliance in these cases by showing that the misrepresentation was material, testifying that he relied upon it, and showing that he traded soon after misrepresentation.

**7.WHEN NONDISCLOSURE CONSTITUTES a VIOLATION**

**a)Mere Possession of Material Information**--generally, nondisclosure of material, nonpublic information violates rule 10b-5 **only** when there is a duty to disclose independent of rule 10b-5

**b)Insider Trading**--insiders (dirs, officers, controlling shs and corporate employees) violate rule 10b-5 by trading on the basis of material, nonpublic info obtained through their positions. They have a duty to disclose before trading.

**c)Misappropriation**--the liability of noninsiders who wrongfully acquire (misappropriate) material nonpublic info has not been ruled upon by the US Supreme Court, although some lower level federal courts have imposed criminal liability.

1)Duty to Employer--using the misappropriation theory, **criminal liability** under rule 10b-5 has been imposed where an employee trades on info used in violation of the employee’s fiduciary duty to his employer. An employee’s duty to “abstain or disclose” with respect to his ER does NOT extend to the general public. However, the Insider Trading and Securities Fraud Enforcement Act of 1988 makes any person who violates rule 10b-5 by trading while in possession of material, nonpublic info liable to **any person** who, contemporaneously to the transaction, purchased or sold securities of the same class. Liability is limited to the defendant’s profit or avoided loss.

2)Mail and wire fraud--the application of the federal mail and wire fraud statute to this situation lessens the importance of the misappropriation theory in imposing criminal liability under rule 10b-5.

3)Special rule for tender offers--once substantial steps toward making a tender offer have begun, it is a fraudulent, deceptive, or manipulative act for a person possessing material information about the tender offer to purchase or sell any of the target’s stock, if that person knows that the info is nonpublic and has been acquired from the bidder, the target, or someone acting on the bidder’s or the target’s behalf.

**d)”Disclose or Abstain”**--nondisclosure by a person with a duty to disclose violates rule 10b-5 **only** if he trades (Cady rule)

**8.LIABILITY OF NONTRADING PERSONS FOR MISREPRESENTATION**--a nontrading corp or person who makes a misrepresentation that could cause reasonable investors to rely thereon in the purchase or sale of securities is liable under rule 10b-5, provided the scienter requirement is satisfied.

**9.LIABILITY OF NONTRADING CORPORATION FOR NONDISCLOSURE**--the basic principle is “disclose or abstain.” Thus, a nontrading corp is generally not liable under rule 10b-5 for nondisclosure of material facts.

**a)Exceptions**--a corp has a duty to:

1)Correct misleading statements (even if unintentional);

2)Update statements that have become materially misleading by subsequent events; 3)Correct material errors in statements by others (e.g, analyst’s report) about the corp, but only if the corp was involved in the preparation of the statements; and

4)Correct inaccurate rumors resulting from leaks by the corp or its agents.

**10.TIPPEE AND TIPPER LIABILITY**--a person, not an insider, who trades on info received from an insider is a tippee and may be liable under rule 10b-5 if he received info through an insider who breached fiduciary duty in giving the info, AND the tippee knew or should have known of the breach (Dirks)

**a)Breach of Insider’s Fiduciary Duty**--whether an insider’s fiduciary duty was breached depends largely on whether the insider communicated the info to realize the gain or advantage. Accordingly, tips to friends or relatives and tips that are a quid pro quo for a past or future benefit from the tippee result in fiduciary breach. Note that if a tippee is liable, so is the tipper.

**11.”TEMPORARY INSIDERS”**--corporate info legitimately revealed to a professional or consultant (e.g., accountant) working for the corp may make this person a fiduciary of corp

**12.AIDERS AND ABETTORS**--liability cannot be imposed solely because a person aided and abetted the violation of the rule.

**13.APPLICATION OF RULE 10B-5 TO BREACH OF FIDUCIARY DUTY BY DIRECTORS, OFFICERS, AND CONTROLLING SHAREHOLDERS.**

**a)Ordinary Mismanagement**--a breach of fiduciary duty not involving misrepresentation, nondisclosure, or manipulation does NOT violate rule 10b-5;

**b)Misrepresentation or Nondisclosure**--if this is the basis of a purchase from or sale to the corp by a dir or officer, the corp can sue the fiduciary under rule 10b-5 **and** also for breach of fiduciary duty. If the corp doesn’t sue, a minority sh can maintain a **derivative** suit on the corporations behalf.

**c)Purchase or Sale By Controlling Shareholder**--when a corp purchases stock from or sells stock to a controlling sh at an unfair price, and material facts aren’t disclosed to minority shs, a derivative action may lie if the nondisclosure **caused a loss** to the minority shs. The plaintiffs must establish **causation** by showing that an effective state remedy (e.g., injunction) was foregone because of nondisclosure.

**14.BLUE CHIP RULE--PRIVATE PLAINTIFF**--a plaintiff can bring a private cause of action only if he actually purchased or sold the relevant securities. “Sale” includes an exchange of stock for assets, mergers and liquidations, contracts to sell stock, and pledges. The SEC can bring action under rule 10b-5 even though it has neither purchased or sold securities.

**15.DEFENSES**

**a)Due Diligence**--if a plaintiff’s reliance on a misrepresentation or omitted fact could have been prevented by his exercise of due diligence, recovery may be barred. Mere negligence does NOT constitute a lack of due diligence, although a plaintiff’s intentional misconduct and his own recklessness (if D was merely reckless) will bar recovery.

**b)In pari delicto**--a private suit for damages under rule 10b-5 will be barred if:

1)The plaintiff bears **substantially equal responsibility** for the violations, AND

2)Preclusion of the suit would not **significantly interfere** with the enforcement of securities law.

**16.REMEDIES**

**a)Out-of-pocket Damages**--this is the difference between the price paid for stock and its actual value.

1)Compare--benefit-of-the-bargain damages--these are measured by the value of the stock as it really is and the value it would have had if a misrepresentation had been true.

2)Standard measure of conventional damages--out-of-pocket damages is the standard measure in private actions under rule 10b-5; benefit-of-the-bargain damages are usually not granted.

**b)Restitutionary Relief**--this may be sought instead of conventional damages:

1)Rescission--returns the parties to their status quo before the transaction

2)Rescissionary or Restitutionary damages--money equivalent of rescission

3)Difference between conventional damages and Restitutionary relief--out-of-pocket damages are based on the P’s loss, while Restitutionary relief is based on the D’s wrongful gain. Rescission or Rescissionary damages may be attractive remedies when the value of the stock changed radically after the transaction. However, Restitutionary relief is usually unavailable in cases involving publicly held stock.

**c)Remedies Available to the Government**--although the SEC cannot sue for damages, it can pursue several remedies including special monetary remedies:

1)Injunctive Relief--the SEC often seeks injunctive relief accompanied with a request for disgorgement of profits or other payments that can be subject to **criminal sanctions** (fines and jail sentences) and **civil penalties** (up to three times the profit gained or loss avoided).

**17.JURISDICTION, VENUE, AND SERVICE OF PROCESS**--suits under 10b-5 are based on the 1934 Act, and exclusive jurisdiction is in the federal district courts. State claims arising out of the same transactions may be joined with the federal claim under the supplemental jurisdiction doctrine. Venue can be wherever any act or transaction constituting a violation occurred, or where the D is found or transacts business. Process can be served where the D can be found or where he lives.

**18.STATUTE OF LIMITATIONS**--the 1934 Act contains no SOL; however, the SCt has held that **private** actions must be brought within **one year** after discovery of the relevant facts and within **three years** following accrual of the cause of action. The tolling doctrine is inapplicable.