

INSIDER TRADING

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What is Insider Trading?

Buying or selling securities on the basis of:

- material
- non-public information
- in breach of a duty of trust or confidence owed
- directly or indirectly
- to an issuer, the issuer's shareholders or the source of the information

Statutory Basis for Insider Trading

- Section 10 makes it unlawful to “use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of rules” promulgated by the SEC.
- Rule 10b-5 makes it unlawful 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.”

Based upon these statutory provisions, the Supreme Court has recognized three general theories of insider trading liability:

- Classical
- Tipper-Tippee
- Misappropriation

Classical Theory

- Applies when an insider, in violation of a fiduciary duty to his or her company, trades in the securities of the company on the basis of material, non-public information obtained by reason of the insider's position.

Tipper-Tippee Theory

- Imposes liability when (1) the tipper “has breached his fiduciary duty to the shareholders by disclosing the [material, non-public] information to the tippee”, (2) the tippee “knows or should know that there has been a breach”, and (3) the tipper incurred some personal benefit in return.

A note:

- The tipper and the tippee are held equally liable, as long as the tippee has knowledge or reason to know of the tipper’s breach of duty.

Misappropriation Theory

- Applies to the situation where a person, who is not an insider, lawfully comes into possession of material, non-public information, but nevertheless breaches a duty owed to the source of the information by trading on the basis of such information or by conveying the information to another person to trade.

Rule 10b5-2; Definition of Duty of Trust or Confidence

- Under Rule 10b5-2, a duty of trust or confidence arises between a recipient of material, non-public information and the source when: (1) the recipient “agrees to maintain the information in confidence”; (2) the source and recipient “have a history, pattern, or practice of sharing confidences,” such that the recipient knew or reasonably should have known the source expected the information to be kept in confidence; and (3) where the source is the “spouse, parent, child, or sibling” of the recipient.

What are the Potential Legal Penalties for Insider Trading?

- Civil:
 - Disgorgement of any profit made or loss avoided
 - Prejudgment interest
 - Penalty not to exceed the greater of \$1 million and three times profit made or loss avoided
 - Bar from serving as a director or officer of a public company, and if an attorney or accountant a bar from serving in the professional capacity before the SEC
- Criminal:
 - Up to 20 years in prison
 - Fines up to \$5 million or twice the gain from the offense

What are the Potential Legal Penalties for Insider Trading? (continued)

- Private Rights of Action
- Express - Section 20A of the Exchange Act
- Implied - Section 10(b) and Rule 10b-5