Insider Trading v. Trading on Inside Information: A Primer for Management

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Abstract
Insider trading has been a challenge for government regulators, corporate compliance officers, and managers. This area of the law encompasses statutes, case law, and agency rules; it includes civil and criminal liability; and moreover, insider trading can, and has been, very damaging to many people's reputations, careers, "pocketbooks," and freedom. Government prosecutors have charged many well-known individuals for being involved in insider trading schemes, such as trading on confidential non-public information, or passing on confidential stock information, leaking tips, and thereby making money from stock data that is not publicly available. This article deals with securities law regulation by examining certain fundamental legal principles so as to assist managers and other non-legal professionals to comprehend the issues and laws of insider trading. The article thus is intended to educate readers as to these principles while underscoring the potential for liability as well as to show how to avoid liability. Several court cases are presented for illustration and to demonstrate how the courts interpret the laws and thus what the courts might consider to be illegal insider trading. Since the purchase, sale, and transfer of securities are heavily regulated by federal and state statutes as well as the common law, this paper will assist managers in understanding the law and thus taking actions to prevent and to prohibit insider trading as well as other deceptive, fraudulent, manipulative, and unfair trading practices in the securities marketplace. The article explicates the relevant law and then provides practical recommendations for managers, employers, and other professionals to be in compliance with the insider trading laws and other securities laws and policies in the United States of America.

Keywords: Insider trading, inside information, information, material, non-public, trading on inside information, insiders, tippees, Securities and Exchange Commission, SEC Rule 10b5.

I. Introduction

The law in the United States draws certain lines, for example, the line between a "good will" gift to a foreign government official and an illegal bribe under the Foreign Corrupt Practices Act (Cavico, 2015; Cavico and Mujtaba, 2011), or the line between consciously but independently tracking the pricing policies of your competitors and following them and colluding to fix prices in violation of the Sherman Anti-Trust Act (Cavico, Mujtaba, Samuel, and Muffler, 2016). Another important line the law draws emerges in the field of securities law; and that line is the critical distinction between insider trading which is illegal and trading on inside information which *may* be legal.

Insider trading has very recently been "front-and-center" in major media outlets involving an alleged insider conspiracy among an investment banker, the former chairman of Dean Foods, a sports bettor to whom he owed a great deal of money, and the famous, popular, professional golfer, Phil Mickelson, who also owed the sports bettor money. Federal government prosecutors in May of 2016 instituted criminal charges against the investment banker and the sports bettor for the former's passing on confidential stock tips to the sports bettor, generating over $40 million in profits. The sports bettor, who belongs to the same country club as Mr. Mickelson, then passed on the information to his golfing partner, Mr. Mickelson, who also owed the sports bettor money on a gambling debt. However, the Securities and Exchange Commission (SEC) only proceeded civilly against Mr. Mickelson to recover the profits made; and Mr. Mickelson has agreed to repay nearly $1 million on profits he made from the tip. The confidential information dealt with a company, Dean Foods, the nation's largest milk producer, and its plan to spin-off a subsidiary as well as several of the company's quarterly earnings statements. The investment banker has already pled guilty to securities fraud and has agreed to testify against the sports bettor, a long-time friend (Goldstein, Protess and Stevenson, 2016; Viswanatha, Hong, and Rothfeld, 2016). When asked why Mr. Mickelson was not charged criminally, the SEC said that criminal charges were not justified "based upon the evidence and the law" (Viswanatha, Hong, and Rothfeld, 2016, p. A5). Perhaps the SEC believed that the agency could not obtain sufficient evidence that Mr. Mickelson received objective factual information of a stock tip, as opposed to hearing a mere rumor or speculative "loose talk" on the golf course, or maybe the agency felt that they could not convince a criminal jury that Mr. Mickelson was a tippee in conspiracy with the insider investment banker through the sports bettor. Regardless, the "Mickelson case" nicely raises important legal and practical issues that the authors address in this article, to wit: the definition of material, nonpublic, information, the definition and nature of insider trading, the definition of an insider, the existence of conspiracy between an insider and a tippee, and the critical distinction between insider trading and trading on inside information.

The principal purposes of this article are to try to determine as precisely as possible where this line between illegal and legal trading is demarcated, to educate managers as to their responsibilities as well as rights under the law to buy and sell securities, and to provide recommendations to make sure that managers stay on the legal side of the line. As such, the authors review key security law statutes, SEC rules, pertinent case law interpreting statutes and agency rules, relevant legal and management commentary, as well as current events articles.

After this introduction the article commences with a succinct review of U.S. securities law. Three main statutes are addressed: the Securities Act of 1933, the Securities and Exchange Act of 1934, and the Sarbanes-Oxley Act of 2002. Brief mention will also be made of state security law – both statutory and pursuant to the common law tort of fraud (also called "deceit"). Next, the article will examine the most important law governing insider trading – a rule promulgated by the Securities and Exchange Commission known as Rule 10b5, which makes insider trading a crime as well as civil wrong. As per the Rule 10b5 analysis, the article will first establish the foundation for insider trading by examining three necessary components – information, inside information, and material inside information. Then the article will present the two competing theories of liability for insider trading: the broad or "level-playing-field" theory and the narrow or "insider" theory. Pursuant to the narrow theory the article will discuss the three types of people who can be liable for insider trading: "misappropriators," insiders, and tippees in conspiracy with insiders. Then, most significantly, the article will attempt to clearly draw that critical line between illegal insider trading and trading on insider information; and thus point out and explain the two types of people – the "lucky" (known as "inadvertent tippees") and the "smart" (that is, market professionals) – who may be able to legally trade on inside information. The article, moreover, will point out a group of inadvertent tippees who cannot trade on inside information – those in fiduciary relationships with insiders. After presenting the case law illustrations and making reference to legal and management commentary the article will discuss the implications of this critical distinction in the law; and then make practical recommendations to managers so they can stay on the legal side of this line. Finally, the article ends with a brief summary and concluding thoughts.

II. Overview of U.S. Securities Laws

The three most important security laws in the United States are on the federal, that is, national level – the Securities Act of 1933, the Securities Exchange Act of 1934, and the Sarbanes-Oxley Act of 2002. The Securities Exchange Act of 1934 created the Securities and Exchange Commission (SEC) which is a federal independent regulatory agency. The SEC is empowered to administer and enforce securities law in the United States, including investigating securities law violations, to interpret the provisions of federal securities statutes, and, most importantly for the purposes herein, to promulgate rules governing the purchase and sale of securities (and which rules have the force of law) (Cheesman, 2016; Cavico and Mujtaba, 2014; and Clarkson, Miller, and Cross, 2012). This *corpus* of security law is premised on the purchase and/or sale of a "security." For the purpose of this article the authors will treat a security in its traditional sense of being a stock or bond, though certainly other investments and instruments, such as debentures, stock warrants, stock options, as well as investment contracts (which might be a legal interest in a limited partnership), could be construed as a "security" (Cheesman, 2016; Cavico and Mujtaba, 2014; and Clarkson, Miller, and Cross, 2012).

The 1933 Securities Act governs the initial sale of securities by companies to the public. This statute is essentially a disclosure statute. That is, the federal government in the U.S. does not approve or disapprove of any initial sale of securities; rather, the laws "merely" require that the investing public be given sufficient and truthful information about a company, its finances, plans, principal participants and their backgrounds, and other significant information so as to make an informed and intelligent decision about whether to purchase a certain security. This primary disclosure purpose is accomplished by requiring non-exempt corporations to register a security and filing a registration statement with the SEC with the aforementioned information as well as a financial statement certified by an independent CPA. Moreover, the 1933 Act requires a corporation to provide to the investing public a prospectus which describes the security being sold, the financial condition and operations of the issuing company, as well as the risk of the investment being offered. Any intentional, knowing fraudulent statements or material omissions in the registration statement and/or prospectus will bring about civil and criminal liability, including imprisonment for up to five years (Securities Act of 1933; Cheesman, 2016; Cavico and Mujtaba, 2014; and Clarkson, Miller, and Cross, 2012). Any examination in depth of the 1933 Act is beyond the scope of this article, which will concentrate on the 1934 Act.

The 1934 Securities Exchange Act is a very broad anti-fraud statute. Section 10(b) makes illegal – civilly and criminally – any knowing, intentional, and material misrepresentations, fraud, deceit, omissions, as well as manipulation regarding the purchase and sale of securities (Securities Act of 1934; Cheesman, 2016; Cavico and Mujtaba, 2014; and Clarkson, Miller, and Cross, 2012). Manipulation can be in the form of "pump and dump" schemes, making false "tips" under aliases, and placing false orders (Patterson and Rothfeld, 2014; Smith, 2001). However, the wrongful conduct, it must be emphasized, must be knowing and intentional misconduct (to satisfy the "scienter" or "bad intent" requirement of the law) as opposed to just negligent or careless conduct in making "mere" misstatements or omissions (Cheesman, 2016; Cavico and Mujtaba, 2014; and Clarkson, Miller, and Cross, 2012). In addition to civil proceedings by the SEC and criminal prosecutions by the Department of Justice the courts have recognized a private cause of action pursuant to the 1934 Act whereby an aggrieved private party can institute a civil action for the rescission (that is, cancellation by the court) of the securities contract and transaction and for money damages (that is, restitution in the form of the return of the illegal profits made by the wrongdoer) (Cheesman, 2016; Cavico and Mujtaba, 2014; and Clarkson, Miller, and Cross, 2012).

Pursuant to the 1934 Act, the SEC has promulgated Rule 10b5 which prohibits fraud regarding the purchase and sale of any security. Furthermore, violations of any SEC rules are prohibited by Section 10(b) (Cheesman, 2016; Cavico and Mujtaba, 2014; and Clarkson, Miller, and Cross, 2012). Another principal purpose of Rule 10b5 is to prohibit and prevent "insider trading," which generally means a person is buying or selling securities based on the possession of information not yet available to the public. Also important to mention is SEC Rule 10b5-2 which prohibits people in a relationship of trust and confidence from trading on material confidential information received as part of this relationship (SEC Rule 10b5-2, 2008). As such, pursuant to Rule 10b5-2 if one knows either explicitly or implicitly that information is delivered in confidence, or there is a pattern of sharing confidences between the parties, then the recipient cannot trade on the information (Yadav, 2015). SEC Rule 10b5, the prohibition against insider trading, and the critical distinction between insider trading and "merely" trading on inside information will be focal points of this article. Mention, moreover, needs to be made of another pertinent SEC rule – Rule 14e-3 (2015). This agency law creates a "disclose or abstain" requirement for trading by any person who possesses material inside information about a "tender offer" (that is, a proposal to buy shares of stock from a target corporation's shareholders either for cash or shares of the acquiring corporation) and who knows or should know that the information is nonpublic and comes from the target or acquiring company (SEC Rule 14e-3. 2015).

The 1934 statute and the SEC rule, however, have been criticized for a lack of precision. For example, the *Wall Street Journal* (Matthews, 2014, p. C2) referred to a law school professor at Columbia Law School saying that not only was the 1934 law ambiguous, but "because of the statute's ambiguity, most of the law on insider trading had been set by the courts," which the professor deemed to be "remarkable." Similarly, the *Wall Street Journal* (Zweig, 2011, p. B1) referred to another law school professor, from the UCLA School of Law, who called the area of insider trading "an enormously gray area of the law." Harasmimowicz (2016, p. 769) states that "insider trading liability is a convoluted area of the law." As such, the *Wall Street Journal* (Crovitz, 2015, p. A9) has a warning for business people: "Insider trading is a vexing area of the law because there is no law. The Securities Exchange Act of 1934 has broad antifraud language but no statute defines the crime. The vagueness of 'insider trading' makes it easy for ambitious prosecutors…to stretch the rules." Accordingly, the authors herein hope to clarify this area of the law for management.

The 2002 Sarbanes-Oxley Act (SOX) statute was promulgated as a result of the Enron scandal. One recalls Enron CEO Ken Lay's defense to securities fraud and insider trading, called the "idiot" or "ostrich" defense (Bianco, 2006, p. 58), ultimately unsuccessful, in that he was only a "glad-hander" (that is, a community, charitable, and socially responsible-minded figurehead) and not a "hands-on" CEO who knew that his company was built on a financial "house-of-cards" (Cavico and Mujtaba, 2014; Bianco, 2006). Accordingly, SOX is basically a certification statute whereby Chief Executive Officers and Chief Financial Officers are required to review and certify the "financials" of their companies, and specifically certify that the report contains no untrue statements of material fact and does not omit any material facts (Sarbanes-Oxley Act of 2002; Cheesman, 2016; Cavico and Mujtaba, 2014; and Clarkson, Miller, and Cross, 2012). As with the 1933 law, this statute is beyond the purview of this article except to note that SOX materially expanded the criminal punishment for securities law violations, including insider trading, up to (what some might say as a draconian) 20 years of imprisonment (Sarbanes-Oxley Act of 2002, Section 1106; Cheesman, 2016; Cavico and Mujtaba, 2014; and Clarkson, Miller, and Cross, 2012). Nevertheless, despite the increase in penalties and the increase in prosecutions, Schipani and Seyhun (2016, p. 328) reported that some estimates of the profits gained from insider trading exceed $6 billion a year.

Finally, it also should be briefly mentioned that there also exist in the U.S. state security regulation laws, which typically parallel the federal laws, and which may be used if the federal government does not have jurisdiction (which is rare since securities transactions typically use instrumentalities of "interstate commerce," such as email or telecommunications) or the federal government chooses not to exercise its jurisdiction (perhaps because a securities violation case is too "small") (Cavico and Mujtaba, 2014). On a perhaps quaint historical note, the authors would like to mention that state security statutes are typically called "Blue Sky" laws since their purpose in the "old days" was to protect investors from buying worthless securities – how worthless - as worthless as the deep blue sky! Also on the state level is the common law tort of fraud which is also called intentional misrepresentation; yet this legal wrong is better termed under its old common law of "deceit," which word evidences the requisite "evil mind" and bad intent involved. This tort certainly can be used in fraudulent securities transactions as well in any other deceptive business and contractual dealings. However, the requisite evidence of an "evil mind" as well as a standard of proof for fraud of "clear and convincing" evidence (as opposed to the usual civil standard of a "preponderance" of the evidence) makes this intentional tort a very difficult one to sustain legally (Cavico and Mujtaba, 2014). This article, therefore, focuses on the 1934 Act and the power that Congress gave to the SEC to promulgate rules, specifically the rule against insider trading - Rule 10b5.

III. Securities and Exchange Commission Rule 10b5

A. Insider Trading vs. Trading on Inside Information

Pursuant to the power delegated to the agency by the 1934 Securities Exchange Act, the Securities and Exchange Commission promulgated Rule 10b5, which is the preeminent law in the U.S. governing insider trading. Insider trading is clearly illegal – civilly and criminally. Rule 10b5 holds that it is unlawful for any person, directly or indirectly to use any device, scheme, or artifice to defraud, to make any untrue statement of material fact or to omit any material fact that are misleading, and to do any act, practice, of business that operates or would operate as a fraud or deceit on a person in connection with the purchase or sale of any security (17 *Code of Federal Regulations*, Section 240.10b5) Yet, though seemingly very broad in scope, as will be seen, the law is not a "blanket" prohibition on trading on inside information; rather, the courts have interpreted Rule 10b5 to allow trading in two narrow circumstances. First, though, it is necessary to establish the predicate for insider trading and next to determine who can be liable for insider trading. Finally, the two exceptional circumstances of legally trading on inside information will be explicated.

B. The Legal Foundation for Insider Trading

1. Information

Insider trading is based on trading on material, nonpublic "information." Information thus is the predicate for the legal wrong. As opposed to trade secret law, where the notion of information is broadly construed (Cavico, Orta, Muffler, and Mujtaba, 2014), pursuant to securities law, "information" is much more narrowly defined. Information for the purposes of insider trading is based on objective, factual, historical, and/or scientific information, for example, the earnings report for the last quarter, the merger plan, an impending takeover, or the geologists report on the discovery of natural resources. As such, rumors, speculation, opinions, predictions, and statements in the form of questions are not usually sufficiently factual to be construed as "information" (Cheesman, 2016; Cavico and Mujtaba, 2014; and Clarkson, Miller, and Cross, 2012). Yet a major problem emerges in security law and that is that people do not make predictions, give opinions, or for that matter ask questions, in a vacuum. That is, normally, opinions and predictions as well as questions are based on some facts. Consequently, the perplexing question emerges as to how many "facts" there have to be in a question or "opinion" or a "prediction" to turn it into a legal "fact," and consequently serve as the initial foundation for insider trading liability. The answer to that difficult question is beyond the purview of this article; yet in one sense the answer is "simple" in that a jury would typically have the final say in making that critical determination. Assuming there is the necessary "information," the next step is to ascertain if the information is sufficiently "inside," that is, nonpublic.

2. Inside Information

Once there is "information" the next requirement for legal liability is that the information must be "inside"; that is, the information must be proprietary, confidential, secret, and private. The information must be nonpublic. Once information "goes public" it can be traded on. In order for information to be legally deemed "public," and thus tradable, two requirements must be met: 1) the information must be "disseminated" to as to reach the general securities marketplace, for example, when information appears on the financial wire services; and 2) the information must be "absorbed" by the investing public, which is not the same as dissemination, and which means the information is somehow translatable into investment action (Anderson, 2016, pp. 282-83). For example, in the federal district court case of *SEC v. Ingoldsby* (1990), the court ruled that a press release was not fully absorbed into the market until nine days after its release. As such, Anderson (2016, p. 283) emphasizes: "Just when information is translatable into investment action is not clear, and opinions vary widely on this point." Moreover, the Securities and Exchange Commission maintains that investors must wait a "reasonable" amount of time after disclosing the information before trading (Schipani and Seyhun, 2016).

Yet, "what constitutes a reasonable time depends on the circumstances of the disclosure" (Schipani and Seyhun, 2016, p. 342). In addition, the agency has rules as to "windows" for insiders to trade on information that has gone public (Cheesman, 2016; Cavico and Mujtaba, 2014; and Clarkson, Miller, and Cross, 2012).

However, it must be noted that the fact that information could be discovered by others does not necessarily make it "public" in all respects. To illustrate, in one federal district court case two railroad employees apparently learned of a pending acquisition of their employer by means of observation while they were working, specifically seeing that visits of people wearing suits were coming to the rail yard and using a special rail car used for visitors. The court denied a motion to dismiss the case on grounds that the information was public (*SEC v. Steffes*, 2011). Of importance in the case was the fact that the jobs of the workers gave them access to this information and that they signed agreements not to disclose or use confidential information (*SEC v. Steffes*, 2011).Examples of non-public inside information have been:

- earnings reports (*United States v. Newman*, 2014; *SEC v. Dorozhko*, 2009),
- natural resources discoveries (*SEC v. Texas Gulf Sulphur Co*., 1968),
- tender offers (*United States v. O'Hagan*, 1997),
- corporate mergers and takeovers (*United States v. Salman*, 2015; *Chiarella v. United States*, 1980),
- evidence of company fraud in the form of inflated asset prices (*Dirks v. SEC*, 1983),
- financial plans for funding the company (*U.S. v. Cuban*, 2010),
- the sale of the company to another company (*United States v. McGee*, 2014),
- a change in leadership (*SEC v. Ingoldsby*, 1990),
- the fact that the company was going to be sold at a much higher price than its market value (*United States v. Chestman*, 1991),
- the fact that the company would be receiving fewer orders from one of its largest customers (*SEC v. Adler,* 1998),
- the fact that the company had a list of companies it would not trade with because the company was working on transactions with those companies (*United States v. Teicher*, 1993),
- a reduction in earnings (*Investors Management Co. v. SEC*, 1971).

However, even if the information is deemed to be legally "information," and even if it is deemed inside and non-public, there is still one more step in determining liability – the "materiality" of the information.

3. Material Inside Information

In order to serve as the foundation for legal liability the non-public information must be "material." The U.S. Supreme Court in the case of *Basic, Inc. v. Levinson* (1988) emphasized that there are two requirements for materiality of information: 1) "a substantial likelihood that a reasonable shareholder would consider it important" in buying or selling securities; and 2) "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 the information available" (pp. 231-32). The Second Circuit Court of Appeals had previously stated the following factors: whether a reasonable person would attach importance to the information in determining his or her choice in the transaction in question; and whether the information under reasonable and objective contemplation would affect the value of a company's stock (*List v. Fashion Park, Inc*., 1974).

Materiality, in essence, is information which the reasonable investor might believe would be likely to cause an increase or decrease in the price of the shares of stock based on all the information available to him or her, for example, information regarding a merger or fundamental corporate change, a profit or loss announcement, a dividend change up-or-down, a new discovery of natural resources or a product or process, bankruptcy or reorganization, or lawsuits against the firm (Cheesman, 2016; Cavico and Mujtaba, 2014; and Clarkson, Miller, and Cross, 2012). A leading case as to "materiality" is the federal appeals court case of *SEC v. Texas Gulf Sulphur Co*. (1968), where the court held that the company's discovery of a rich ore deposit was "material," and thus several of its insiders, including directors, officers, and employees, could not trade on the information before an announcement of the discovery because the information would affect the judgment of reasonable investors. Other examples are the federal district court case of *United States v. Corbin* (2010) where information pertaining to numerous impending acquisitions of publicly traded companies was deemed to be material; and the Supreme Court case of *Dirks v. SEC* (1983) where the fact that the company had overstated its assets due to fraudulent accounting practices was also deemed to be material.

However, as with a great deal of securities law, the definition of "materiality" is not a precise one. As such, Anderson (2016, pp. 279-80) asks: "Who is the 'reasonable shareholder' or 'reasonable investor'? Is she small or institutional, a short-term speculator or a long-term investor? What constitutes a 'total mix' of information"? The *Wall Street Journal* (Chasen and Rubenfeld, 2015, p.B4) note that regarding "materiality", "There is a lot of gray area." Chasen and Rubenfeld (2015, p.B4) also suggest that "material" information might go beyond the traditional financial report type of information, such as sales and earnings figures, and thus could encompass "customer churn" and the "impact of foreign currencies." Schipani and Seyhun (2016, p. 329) relate that the materiality of some information is clear, for example, corporate takeovers, earnings announcements, and dividend announcements, yet they add: "Equally unclear is the legality on other types of valuable information, such as corporate structuring, new security issues, corporate borrowing decisions, personnel changes, all of which can significantly impact stock prices." They too argue that the term "material" is "ambiguous" (Schipani and Seyhun, 2016, p. 329). Moreover, the fact that the *Basic* materiality standard is subject to multiple interpretations causes Anderson (2016, pp. 279-80) to warn that "under any reading, the *Basic* standard demands a fact-intensive analysis that will expose even the most thoughtful and diligent advance planning to second-guessing by regulators and the courts *ex post*." Nevertheless, even if there is information which is nonpublic and confidential, if such information is deemed to be immaterial then one can safely trade on it. Now, assuming that information is inside and material, the next step is to be aware of the two competing theories of liability for trading on such information – the broad theory and the narrow theory.

C. The Two Competing Theories of Liability

1. The Broad or "Level-Playing-Field" Theory

There are two competing legal theories pertaining to the legality of trading on inside information – the broad theory, also called the "level-playing-field" theory, and the narrow theory, also called the "insider" or "misappropriation" theory. Pursuant to the broad theory, anyone who knowingly trades on material, inside information, however acquired, commits a legal wrong, which is why the theory is at times called the "level-playing-field" theory (Cheesman, 2016; Cavico and Mujtaba, 2014; and Clarkson, Miller, and Cross, 2012). Coffee (1990) very nicely stated and compared the two theories, to wit:

> The first and narrower theory holds that the corporation has a property right in its confidential business information that it develops' thus, when its employees or agents trade on such information, they are essentially stealing…this corporate asset. The second theory is based on broader notions of fairness and equity and postulates that all who trade in the securities markets are entitled to a level playing field; from this perspective it is wrongful for anyone to trade on material, nonpublic information, however, acquired (p. A16).

Similarly, Harasmimowicz (2016) explains the rationales behind the two theories. The narrow theory is based on an "efficient market" rationale, to wit:

> The efficient market rationale promotes investor confidence in the securities market by assuring that a security's price promptly reacts to new and unexpected information. Under this rationale, trading based on material, nonpublic information contributes to efficient stock market pricing because information relevant to a stock's value becomes embedded in stock prices more quickly than if the public had to wait until such information is disclosed. Additionally, the efforts of market professionals, such as analysts, help bring security prices in line with the underlying value of the asset. The profits made by these market professionals are therefore an appropriate reward for their labor (pp. 772-73).

Whereas the broad theory, Harasmimowicz (2016) states, is based on "fairness" and a "parity of information" rationale, to wit:

> The fairness rationale is based on the premise that federal securities laws should create a system that provides equal access to information in the securities market, a parity of information, which is necessary for investors to make reasoned and intelligent investment decisions. According to this rationale, using information not generally available to the market to trade in securities is fraudulent because it gives corporate insiders with access to information an unfair advantage over less informed shareholders or other buyers and sellers of securities. Investors would be discouraged from participating in the securities market because they would have no way of knowing whether they were at an unfair disadvantage. Under this fairness rationale, insider trading is undesirable because it is fundamentally unfair to those investors lacking the same access to information as insiders. The uninformed investor is harmed to the extent he or she would have made a different investment decision had he or she had access to the same information (p. 771).

However, the broad legal theory, though based on "notions of fairness and equity," is merely the historical one, provided by the authors for comparison purposes. Rather, the prevailing legal theory is now the narrow or "insider" one, though from an ethical standpoint, especially pursuant to Kantian ethics, it can be argued that the older, historical, broad theory is the moral one. For example, Klaw (2016, p. 285) declares that based on Kantian ethics "trading on the basis of information that is inaccessible to the public is ethically repugnant." Premised on Kant's Categorical Imperative, specifically the Kingdom of Ends test, which requires human beings to be respected and thus treated as worthwhile and valuable "ends" and not as mere means or instrumentalities to an end, Klaw (2016) explains:

> We deny another's ability to provide…consent when we deceive them, coerce them, or otherwise fail to provide them with the information that would provide them, as rational beings

> deserving of respect, the ability to make their own informed judgments. In the case of securities transactions that depend on counterparties being unaware that we possess information that they could never possess through their independent diligence, we deny them the opportunity to make such choices as their own (p. 314).

Yet, regardless of any moral or ethical debate, the narrow theory is the law today. Yet, as the discerning reader will soon see, the "narrow" theory is not quite that narrow.

2. *The Narrow or "Insider" or "Misappropriation" Theory*

a) "Misappropriators".

Misappropriation of material inside information and then trading on the information is a civil and criminal law wrong under securities law. The narrow theory will be divided by the authors into three types of wrongdoers – misappropriators, insiders, and tippees of insiders. "Misappropriators" are thieves who steal or "hack" (illegally accessing and stealing information from computer servers) inside information, or people who bribe insiders for the information, or who employ fraud, deceit, or trickery to obtain inside information. In addition to the securities law violations "misappropriators" would be liable for the theft, computer, bribery, and fraud offenses (Cheesman, 2016; Giger,, Riley, and Robertson, 2015; Cavico and Mujtaba, 2014; and Clarkson, Miller, and Cross, 2012). Basically, the "misappropriator" stole inside information and then traded on it; and, as such, the authors, though not criminal defense attorneys, would advise the wrongdoer to plead guilty to the state theft charge in return for perhaps a dismissal of the securities fraud charge since if found guilty the sentence in the former would likely be in months whereas the latter in years.

b) Insiders.

Corporate insiders who trade on their own company's inside information clearly commit a legal wrong. The disadvantages and harm to innocent and ignorant third parties - shareholders or members of the general public, who buy from or sell stock to the insiders under such circumstances are patent. Yet, the question arises as to who exactly is an "insider"? Moreover, here, one is confronted with a bit paradoxical situation in securities law; that is, the key foundational element of "information" is narrowly construed; whereas the definition of an "insider" is very broadly construed. Insiders include the company's directors, officers, and employees (though it is likely that only the higher level employees and their assistants) will have access to confidential information; but the term has been interpreted to encompass not only technical "employees" but also "outsiders" in the form of independent contractors, consultants, and agents, such as the company's non-employee sales force, lawyers, accountants, investment bankers, and stockbrokers (Cheesman, 2016; Cavico and Mujtaba, 2014; and Clarkson, Miller, and Cross, 2012). Moreover, even majority and/or large shareholders have been viewed as "insiders." Even a company's financial printers can be construed as "insiders," such as in one case where the company's outside printer wrongfully obtained non-public information which he had acquired while working as a "mark-up man" preparing documents for printing regarding a pending corporate takeover (*Chiarella v. United States*, 1980). Furthermore, the health care professionals used by the company as part of its wellness or health care program can be construed as "insiders" (Cheesman, 2016; Cavico and Mujtaba, 2014; and Clarkson, Miller, and Cross, 2012). Actually, Rule 10b5 and the prohibition against insider trading can apply not just to insiders but to any person who has obtained confidential non-public information and then trades on the information. As such, the discerning reader recalls an important point the authors initially made; and that is the more vague, and thus subject to more expansive interpretation, a law or part thereof is, the more power is granted to government regulators and prosecutors; and such a result plainly is the case here with the definition of an "insider" under securities law.

c) Tippees in Conspiracy with Insiders.

Now, a corporate insider is not going to be so stupid (Is s/he?) to personally trade on the company's confidential information. Rather, typically, the insider will pass the information along to a spouse, family member, friend, or trusted "outsider" in the form of "tips," and this person will do the trading. If the person who receives the information is deemed to be the "tippee" of the insider there is potential liability for both pursuant to insider trading law (Cheesman, 2016; Cavico and Mujtaba, 2014; and Clarkson, Miller, and Cross, 2012). However, the courts require that the tippee be in conspiracy with the insider, which is a difficult evidentiary burden for the government to surmount, especially if there is a long and attenuated communication chain between or among (multiple) parties (Cheesman, 2016; Cavico and Mujtaba, 2014; and Clarkson, Miller, and Cross, 2012). To illustrate, recall the insider trading saga of Martha Stewart who was *not* prosecuted for the crime of insider trading due apparently to the length and attenuation of the communication chain (insider-senior broker-junior broker-Martha Stewart-Long Island friends and associates of Martha Stewart); but who *was* prosecuted successfully for the crimes of lying under oath and obstruction of justice for attempting to cover up the illicit insider trades. She was sentenced to five months in prison and five months "house-arrest" and paid millions of dollars in civil fines, penalties, and as a result of a class-action lawsuit (Waters, 2006). As such, remember the maxim made "popular" during President Richard M. Nixon's impeachment: "It's not the crime but the cover-up."

The courts also require as part of this insider trading conspiracy that the insider who tipped off the recipient tippee be in breach of a fiduciary duty as well as actually receive something of personal tangible benefit for passing along the information; and also that the tippee knew (or should have known) of the breach of the fiduciary duty, that the information was not public, and that the tippee received a benefit from the information too (Stockman, 2015; Kendall, 2015; and Matthews, 2014; Protess and Goldstein, 2014). There are two federal appeals court cases attempting to define this "benefit" that the tipper must receive before the law is violated. And the big problem is that these decision are contradictory, meaning that ultimately the U.S. Supreme Court is going to have to resolve the issue. The first case is the federal Second Circuit Court of Appeals decision in *United States v. Newman* (2015). In that case, the court held that for a criminal conviction not only must the government prove beyond a reasonable doubt that the insider disclosed confidential information to the tippee but also that the insider "did so in exchange for a personal benefit" (*United States v. Newman*, 2014, p. 446). The case is significant because the court asserted that neither the fact that the insider received "career counselling" from the tippee nor the fact that there was a casual or "social relationship" between the two was sufficient to establish a "personal benefit" (*United States v. Newman*, 2014, p. 452). Clearly, now, at least in the Second Circuit, the requisite personal benefit to the insider is going to have to be considerably more tangible. However, soon after *Newman*, the Ninth Circuit Court of Appeals enunciated a contradictory opinion in *United States v. Salman* (2015), where the tipper, an investment banker, without asking or receiving any type of tangible benefit in return, provided advance tips of takeover deals to his brother, who then freely gave them to his brother-in-law, Salman. The Ninth Circuit upheld the criminal conviction of Salman; and in so doing the court expressly declined to follow the *Newman* decision. The *Salman* court rather held that "proof that the insider disclosed material nonpublic information with intent to benefit a trading relative or friend is sufficient to establish the breach of the fiduciary duty element" (*United States v. Salman*, 2015, pp. 1093-94). So, such is the confusing state of the law until the Supreme Court decides which Circuit's approach to "benefit" – "tangible" v. family/social - is the correct one.

Assuming some sort of legally recognized "benefit" as well as the other legal requirements, the insider tipper, the tippee as well as any remote tippees (down-the-chain of communication) are thus potentially liable civilly for fines and restitution for any profits made from their illegal insider trading conduct (Cheesman, 2016; Cavico and Mujtaba, 2014; and Clarkson, Miller, and Cross, 2012). The aforementioned parties are also subject to criminal prosecution and punishment, which as per SOX, can include lengthy prison terms. For example, a hedge-fund manager was given a six and one-half year sentence for being part of a "criminal club" of hedge-fund managers who tipped each other on non-public information about technology companies (Bray, 2013). An even more severe example is the case of another hedge-fund manager who was given an 11 year prison term for making more than $50 million in illicit profits from tips through insiders at tech companies and brokerage houses, though the government initially asked for a 19 year sentence (Popper and Hamilton, 2011).

To further underscore the perplexity of this area of the law the authors need to point out that the narrow theory is at times called the "classical theory," based on an older Supreme Court case (*United States v. O'Hagan*, 1997), which theory covers true insiders, that is, employees of the company trading their company's shares. The other theory designated by the Supreme Court in the *O'Hagan* case is the "misappropriation theory," which covers trading by persons who are neither employees of nor affiliated with the company (*O'Hagan v. United States*, 1997). Under the rubric of the "misappropriation theory" not only are "misappropriators" (that is, thieves, etc.) covered but also "outsiders" (that is, tipees of insiders) (Anderson, 2016; Shotbarger, 2015; Stockman, 2015; Strader, 2015). What the authors herein have done is to try to clarify this area of law, and thus not to use the standard "classical" v. "misappropriation" dichotomy, but rather to break down the narrow theory into three distinct though related components. Yet regardless of any definitional as well evidentiary problems inherent in this body of law, the general rule is that misappropriators, insiders, and tippees in conspiracy with insiders commit serious legal wrongs – criminal and civil – for insider trading. So, then, who can trade on inside information? There are two "exceptional" situations for people legally trading on inside information – the "lucky" and the "smart."

IV. Legally Trading on Inside Information

1. The "Lucky" – Inadvertent Tippees

a) The Exception.

It's always good to be lucky, right? To have, as Machiavelli said, "the Goddess Fortuna to smile at you." So, perhaps such a "fortunate" person hears or sees something that he or she was not supposed to, for example, two CEOs loudly talking in the elevator about the planned merger (which obviously they should not be doing and very likely which talk their corporate code of conduct prohibits). Assuming there was no impermissible eavesdropping, hacking, monitoring, or surveillance, the recipient of the information merely happened to be "at the right place at the right time," and thus "stumbled" on the information. Accordingly, this "lucky" person, called in the law an "inadvertent tippee," can legally trade on the information, which technically is "inside" information (Cheesman, 2016; Cavico and Mujtaba, 2014; and Clarkson, Miller, and Cross, 2012). The inadvertent tippee exception, therefore, does provide some legal latitude for trading on inside information but only if one is "lucky" (and then knows how to intelligently "leverage" his or her luck!).

b) The Exception-to-the-Exception – Inadvertent Tippees in Fiduciary Relationships.

The inadvertent tippee rule, however, is constrained by one exception – well, technically, an exception-to-the exception – the "inadvertent tippee" in a fiduciary relationship rule. This rule holds that if one is a professional, for example, a doctor, lawyer, accountant, psychiatrist, psychologist, etc., in a fiduciary relationship (that is, one of trust and confidentiality) with a patient or client, and if the professional happens to hear or see something of a confidential nature, then the professional cannot trade on the information; and to do so would be a violation of the fiduciary relationship as well as a legal wrong under securities laws (Cheesman, 2016; Cavico and Mujtaba, 2014; and Clarkson, Miller, and Cross, 2012).

2. The "Smart" – Market Professionals

One other category of people can legally trade on inside information – the "smart." These people are typically market professionals, that is, security analysts, who based on legitimate public sources of information, and using their own knowledge, skills, and intelligence make deductions (presumably correct ones!) that reflect certain information that is not yet public (Cheesman, 2016; Cavico and Mujtaba, 2014; and Clarkson, Miller, and Cross, 2012). To present a hypothetical example (though one the authors think is based on reality, especially in the airline and banking industries): say two companies, the second and fourth "players" in their market, publicly announce a merger, which if approved by the government would result in the combined company being number one in the market. As a result, a shrewd market professional believes that the government will approve the merger *and* that competitive pressures will result in the merger of the first and third concerns. The market professional then buys "heavily" into the stock of the third-place company, surmising that the number one company will pay a premium for its shares in order to maintain its dominant position in the market. The market professional is correct in his/her regulatory approval belief as well as correct in the merger deduction (which had actually been formulated by the companies in a "top secret" merger plan) and the high share price. The market professional is a very good "speculator" and makes a substantial profit – legally! Market professionals, as in the preceding example, are not insiders; they do not steal anything; no one tipped them off; they are diligent, resourceful experts in certain sectors of the economy, and of course very smart (and hopefully a bit lucky too). Any person, theoretically, can be a market professional (assuming the time, effort, money, and education involved) or one can hire market professional to do one's trading or simply read their views in publications or watch them on the media.

This "smart" exception can be justified on the Utilitarian grounds that it is good for the markets, the economy, and society as a whole to allow market professionals to "ferret out" and deduce by legitimate means information that is still technically "inside." Coffee (1990, p. A16) similarly justifies the narrow theory on Utilitarian grounds by stating that so long as there is no bribery or theft "all investors, large and small, benefit from the…search for new information. A perfectly level playing field thus means a slower, less accurate market." Epstein (2016, p. 1513) further explains the rationale for this theory:

> No dynamic market is perfectly competitive. Indeed innovation depends on astute individuals finding ways to take advantage of gaps in markets, and it is through their efforts to gain extra returns that the system starts to hum. There are always entrepreneurial individuals who invest resources in an effort to locate new bits of information that will give them a leg up, which translates into higher rates of return for greater amounts of work. The more people who seek to exploit this information, the better markets will work (p. 1513).

Market analysts under the protection of the narrow theory, therefore, can perform a valuable service of making more information available to the stock market and the investing public, thereby ensuring that the market value of stocks more accurately reflects their true underlying value. The overall positive result is a more efficient market.

V. Implications

Insider trading is the unlawful trading of securities based on material nonpublic information. Furthermore, people associated with insider trading might also lose their industry credibility once the information is quickly spread through social media (Cavico, Mujtaba, Muffler and Samuel, 2013). Despite the presence of real-time communication through social media, the critical term "insider trading" is not well-defined in federal securities law. Moreover, another major problem is that the U.S. Congress, the courts, and the SEC have not provided clear definitions and criteria for what is "material" and "nonpublic" information. Furthermore, in order to be found guilty or liable for insider trading there first must be established the predicate – information, non-public information, and material, non-public information.

Another problem is the legal requirement of "scienter," which is a required element to a crime and an intentional tort, such as fraud or deceit. Scienter is the presence of an "evil mind" or the bad intent to commit a wrong; that is, the wrongdoer knew what he or she was doing was wrong under the law but nonetheless purposefully committed the wrongful actions to cause harm to a victim (Cavico and Mujtaba, 2014). "Scienter" harkens back to the old common law tort of deceit which requires evidence of a "bad" mental state to knowingly and intentionally deceive or to defraud (Cavico and Mujtaba, 2014). The "scienter" requirement is certainly applicable to security law violations though it is difficult for the government to get evidence "inside one's head" of bad intent or otherwise. Is one an "evil" tippee in conspiracy with an insider or merely a "good" (and perhaps lucky) person who heard a rumor and some speculative talk about a takeover casually mentioned at the deli (or golf course)? Evidence of bad intent can be direct or indirect, that is, circumstantial or inferential. In the context of security law violations, the fact that the insider received a personal benefit from trading or passing on the information is evidence of bad intent; and also the fact a tippee, even a remote tippee, knew of the personal benefit going to the insider is also sufficient (Harasmimowicz, 2016).

"Materiality," as pointed out by the authors, emerges as a problematic though critical area of the law since information, even if confidential and not public, is deemed not material, one can legally trade on it. The definition of "material" is, moreover, as emphasized, a vague one. Epstein (2016) states that making a judgment of "materiality" is even more difficult if done in "isolation"; rather, Epstein (2016) says: "Everything depends on context" (p. 1523). As such, Epstein (2016, pp. 1523-24) offers several contextual factors to help make the "material" determination, to wit:

- The number of people who shared in the information.
- The rapidity with which the information is used to make market valuations.
- Whether the information came out in "dribs and drabs" or all at once.
- The availability of other information and the significance of that information and its effect to dilute the allegedly "material" information.
- Whether the information was quantitative, like earnings reports, or qualitative, like strategies.
- The causal connection between the receipt of information and the gains from trading.

Epstein (2016, p. 1524) counsels that this last factor, which he calls the "push-pull" connection, is an important one for government regulators and prosecutors. Harasmimowicz (2016, pp. 779-80) adds that "the materiality standard is extraordinarily broad and potentially encompasses a great deal of information that would have no effect on the value of a company or the pricing of its securities." Yet, as emphasized, by the authors, it is the jury that will make the final determination as to materiality v. immateriality, and if the latter is found, then one can safely trade on the immaterial (though nonpublic) information.

Assuming that the foundation of non-public, material information is present, liability under the "narrow" theory will extend to "misappropriators" (in the more limited sense as used by the authors herein to mean thieves, bribers, hackers, etc.), corporate insiders, and tippees of insiders. Assuming the U.S. Supreme Court agrees with the Second Circuit's *United States v. Newman* (2015) case, the requirements for insider-tippee liability are as follows: 1) the insider was under a fiduciary duty not to disclose confidential information; 2) the insider breached this fiduciary duty by disclosing this confidential information to the tippee; 3) the insider received a tangible (as per *Newman*) personal benefit from the tippee; 4) the tippee knew of the violation of the fiduciary duty; and 5) the tippee used the information to trade for his or her personal benefit or tipped of another individual who similarly benefited. If the *Newman* decision is followed by the U.S. Supreme Court it will be more difficult for the government of establish liability for tippees, of course; nevertheless, corporate insiders who trade on nonpublic, material information or disclose such information for their own personal benefit still clearly commit a legal wrong.

Again, assuming the predicate of non-public, material information has been established, and notwithstanding liability under the general rule, the law does provide legal latitude for trading on inside information in two exceptional cases – trading by the "lucky" and the "smart." One can be "lucky," as noted, as well as be "smart"; and thus use public information to deduce and to speculate as to the existence of information that is still confidential, and trade on that confidential information. Of course, the more speculation and the more of a substantial risk there are in the transaction, the less likely there will be any legal problems. However, if a case involves a corporate insider trading on his or her own firm's inside information, or the tippee in conspiracy with an insider doing the same, it is going to be, realistically speaking, exceeding difficulty for the insider and the tippee to claim that they were "merely" lucky or smart. That point is clear at least, that is, it is illegal for a corporate insider to use material, non-public information to trade in the shares of his or her company's stock. Yet, as underscored, that type of insider trading does not cover all that is potentially illegal.

Nevertheless, also as emphasized in this article, for any type of case the government needs evidence to satisfy its burden of proof and persuasion and to convince a jury of criminal guilt or civil liability. And as Epstein (2016, p.1525) underscored: "To get evidence on particular transactions requires a massive inquiry." Consequently, the more lengthy, attenuated, stretched out, and convoluted the causation chain is between an insider and the ultimate recipient of the information the more difficult it is going to be for the government to persuade "beyond a reasonable doubt" a jury (a unanimous federal jury of 12 people) of a conspiracy between an insider and a tippee; rather, the eventual recipient of the information would contend that what was received was not technically "information" (and thus not illegal) "information," but just some rumors, speculation, or "loose talk" casually overheard (and thus legal to trade on). Moreover, the courts require that the government demonstrate that the tippee knew that the non-public information came from an insider and that the tipper-insider received a personal benefit or tangible reward.

Since the prevailing legal theory is the narrow theory, trading by "lucky" inadvertent tippees and "smart" market professionals may be legal; yet it also may be perceived as unfair ethically as well as financially. Nonetheless, if there is no breach of any duty or violation of the law it may be legal to trade on inside information even though the trader may have an unfair advantage. The law is not ethics or morality, the authors submit, though the law tries to be just. Yet, even under the narrow theory, as emphasized by the authors, the government can "cast a big net," especially considering the vagueness in this area of the law; and thus it behooves managers and other insiders to act very carefully and prudently. As such, the authors would like to offer some suggestions to management on how to avoid legal liability.

VI. Recommendations for Management

Management can certainly do many things to encourage legal compliance regarding insider trading issues in order to keep their employees and firms out of the court systems. Regarding training and awareness, management can plan, organize, lead, and control the process by enhancing the technical, human relations, and conceptual skills of all their employees, suppliers and vendors on a regular basis (Mujtaba, 2014). At a minimum, based on the preceding legal analysis, the authors offer the following recommendations to management and other professionals dealing with inside information and insider trading challenges:

1. Companies must have clearly communicated compliance policies and programs detailing the types of confidential information that must be kept secret as well as stating how insiders are to respond to and deal with such information.
2. Compliance policies and programs must include 1) a published ban on trading of the company's shares based on material nonpublic information; 2) require preclearance with the legal or compliance department before trading; and 3) impose "blackout periods" (that is, a period of time to refrain from trading once the information is made public) (Anderson, 2016, p. 287).
3. If one is an insider with access to confidential non-public information the insider must refrain from trading until the information is made public because to do otherwise is a very serious legal violation.
4. If one is an insider with access to confidential non-public information the insider alternatively must disclose the information to the other party before the insider can buy or sell securities from this party.
5. Be aware that if one is an insider legal liability can result from directly trading in one's firm's stock based on non-public information as well as indirectly, for example, buying or selling the stock of a competitor of one's firm based on inside information about one's company (for example, the creation of a new product or process that will "beat" the competitor's product or process).
6. Management must inform the employees in a Code of Conduct and/or Code of Ethics that neither can they use confidential company information for personal gain in the purchase and sale of securities nor disclose such information to unauthorized people.
7. Management must inform the employees that all material information regarding the company, its operations, financial conditions, earnings or losses, or securities must remain confidential until the information is properly and fully disclosed.
8. Management must inform the employees that any calls or communication from security analysts must be referred to the proper department in the company, for example, the Financial Relations Department.
9. Management must inform the employees that they can buy or sell company stock so long as they do not know of any material, non-pubic information about the company but that they must first notify the legal or compliance department.
10. Institute a qualified "trading plan" as set forth by the SEC for those employees who intend to buy or sell company shares since such a plan is an affirmative defense to insider trading (Anderson, 2016, p. 296). The plan must be written, specify the amount, price and date of the securities to be purchased or sold, must include a "written formula" for plan transactions, and must be entered into in "good faith" and when the insider was unaware of any material nonpublic information (Anderson, 2016, p. 296).
11. Beware of the so-called "expert networks," composed of industry specialists and professionals who provide, pool, and synthesize their knowledge and experience and then sell it to investors, because if the amounts paid to the industry specialists and professionals are too large the implication is that the "expert network" is merely an insider trading "ring," which will bring scrutiny from the government and perhaps civil proceedings and criminal prosecution (Bray, 2011; Pullian, Rothfeld, and Strausburg, 2011; Carey and Johnston, 2010).

VII. Conclusion

This article dealt with securities law regulation. The article was titled a "primer" since it is an examination of certain fundamental legal principles in this area of the law geared for a non-legal readership. The article is certainly not a substitute for a security law attorney. The objective is to educate management as to these fundamental principles and underscore the potential for liability as well as to show how to avoid liability. The basic purposes of securities law are twofold: 1) to provide the investing public with more information and more accurate information so they can make informed investment decisions; and 2) to prohibit and prevent deceptive, fraudulent, manipulative, and unfair practices in the securities marketplace. As one has seen, the purchase, sale, and transfer of securities is heavily regulated by federal and state statutes as well as the common law, though none too precisely. This law is a complex one, with the attendant perplexity exacerbated by the vagueness of key statutes and doctrines.

This article described the three important federal statutes in the U.S. regulating securities transactions: the Security Act of 1933, the Security Exchange Act of 1934, and the Sarbanes-Oxley Act of 2002. The focal point of the article was the 1934 Act and particularly Securities and Exchange Commission Rule 10-b(5) which prohibits insider trading. Insider trading is based on material, inside information, and accordingly the article attempted to define and illustrate these critical foundational elements to this area of the law. Most importantly, it was emphasized that the law makes a critical distinction between insider trading which is illegal (assuming the requisite foundation and sufficient evidence) and trading on inside information which *may* be legal if accomplished by the "lucky" inadvertent tippee and/or the "smart" market professional. We attempted to define and illustrate these two exceptional circumstances in the law. We also provided several practical recommendations for managers, their employers, and others to avoid liability for insider trading and securities fraud. We would like to conclude by providing just one more recommendation – specifically to managers and other corporate insiders, and that is as follows: If the information pertains to the insider's own company, then "Don't be too darn lucky or too darn smart."

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