Précis Paper

Insider Trading

A discussion about insider trading, how it is viewed, investigated and prosecuted in the United States and how the US approach differs from Australia's statutory insider trading provisions.

Discussion Includes

- **Insider Trading and US Law**
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Insider Trading

In this edition of BenchTV, Donna Nagy and Pamela Hanrahan discuss insider trading, how it is viewed, investigated and prosecuted in the United States and how this differs from Australia's statutory insider trading provisions.

Insider trading and US law

1. **In the United States, insider trading is a type of securities fraud that is grounded in the common law concept of misleading silence. The liability arises when a person trades securities on the basis of material, nonpublic information in breach of a duty of trust and confidence that is owed either to a party on the other side of the transaction or to the source of the information.**
2. **There is no specific statutory provision in US law that prohibits insider trading. The law in the US is based on Rule 10b-5 of the *Securities Exchange Act* of 1934 which prohibits fraud in connection with the purchase or sale of securities. For insider trading to violate Rule 10b-5 a prosecutor, the Securities and Exchange Commission, or a private plaintiff must establish that a fraud has been committed.**

Insider Trading and the Australian Statutory Rule

3. **S1043A of the *Corporations Act* 2001 (Cth) prohibits three types of conduct; 1) trading 2) procuring and 3) tipping. The prohibition is triggered when somebody is in possession of information and they know or ought to know that it has the character of inside information.**
4. **Inside information has two features; firstly that it is not widely known and secondly, that it is something that if it were widely known a reasonable person would expect to have a material impact on the price or value of securities**
5. **In Australian law, it does not matter who is in possession of that information; they do not have to be insiders in the sense of being corporate officers and they do not have to have any preceding relationship to the person or entity to whom the information belongs.**

Differences between Australian and US law

6. ***Securities & Exchange Com. v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968) was a US case that premised a Rule 10b-5 disclosure duty on the justifiable expectation of the investing public that everybody who trades securities has relatively equal access to**

material information. In the 1960s and 70s the law in the US was akin to the current law in Australia.

7. In the US case of *Chiarella v. United States*, 445 U.S. 222 (1980), the US Supreme Court rejected this equal-access approach to Rule 10b-5 liability and held that only certain people owe duties of disclosure to parties on the other side of a securities transaction. The US Supreme Court found that such disclosure duties arise from relationships of trust and confidence, such as the fiduciary-like relationship between officers, directors, or employees of a corporation and that corporation's shareholders. This is known as the 'classical theory of insider trading.'
8. However, this theory left holes in the law that were quickly plugged by a second approach to insider trading liability known as the "misappropriation theory." This theory holds that a person commits a fraud in violation of Rule 10b-5 when he secretly misappropriates confidential information for securities trading purposes, in breach of a fiduciary-like duty owed to the source of the information. After many years of acceptance by lower federal courts, the US Supreme Court expressly endorsed the validity of the misappropriation theory in the case of *United States v.* O'Hagan*, 521 U.S. 642* (1997).
9. In Australia, the law prohibiting insider trading is not dependent on the relationship between the parties. Every person has a duty not to trade as long as they have the material non-public information and the person knows or ought to know that the information has that character.
10. In the US, only in the context of a tender offer, when a company makes an offer publicly to accumulate shares as a way of taking over that company, is the law similar to that of the Australian prohibition. Insider trading in the context of a tender offer is regulated under a separate provision of the US Federal Securities laws that is Section 14(e) of the Securities Exchange Act of 1934. Rule 14e-3 states that if a person knows or has reason to know that material, nonpublic information about the tender offer came from the acquiring company or the target company or any official connected with either of those companies you must either disclose that information or abstain from trading.

<u>Conviction</u>

11. In the US insider trading can be charged by the Securities and Exchange Commission in civil enforcement actions brought either in federal district court or in administrative proceedings. The Securities and Exchange Commission can seek a host of penalties including a court-ordered injunction and a financial penalty of up to three times the profit made or loss avoided in the transaction.
12. The Securities and Exchange Commission however, does not have authority to bring criminal insider trading actions. In the United States, under Federal Securities law any willful violation of a statutory provision can trigger criminal consequences in

prosecutions brought by the Department of Justice. Penalties under the criminal law can include criminal fines and jail time up to 20 years per offence.

13. In Australia, insider trading can result in civil penalties or a criminal prosecution. Civil penalties against an individual can be up to $1,050,000.00 or 3 times the benefit derived from the trading, and for a corporate up to 10 times that amount or 3 times the benefit derived or 10% of the turnover for the company in the year leading up to the trading. Under the criminal regime, similar to the US the regulator ASIC cannot bring the proceedings themselves and these are referred to the Commonwealth Director of Public Prosecutions.

Corporations and prosecution for insider trading

14. In Australia, insider trading charges can be brought against corporations themselves without officers or directors being subject to proceedings.
15. In the US, it is the actions by the individuals that trigger the intent or recklessness that is necessary to establish the securities fraud. In criminal insider trading cases in the US, the defendant has had to have acted willfully. As a result, in the US for a charge of insider trading to be brought, there must always be an individual who had the requisite mental state to commence proceedings against a corporation.
16. In Australia, the only thing that is relevant is whether the entity itself had the relevant knowledge

Salman v United States **2016 137 S. Ct. 420 (2016)**

17. *Salman v United States* 2016 137 S. Ct. 420 (2016) was a case in the US which involved a Citigroup investment banker who shared information and therefore violated his confidentiality duties to the investment bank and his clients. He shared information with his brother knowing that his brother was going to use it to trade securities. The brother traded securities based on this information and "tipped" a friend, who also used that information to trade. The friend argued that under a ruling of a lower court, the investment banker did not share the information for a personal benefit and therefore he could not be sentences to prison.
18. The Supreme Court then ruled that gifts of information can constitute a personal benefit as gifting inside information to a trading friend or relative is a breach of loyalty that when kept secret constitutes securities fraud under Rule 10b-5.

Disclosure

19. **In the United States, there is no continuous disclosure requirement for publicly traded or private companies. Publicly traded companies in the United States must disclose information periodically in quarterly and annual reports filed with the Securities and Exchange Commission and upon the triggering of certain events enumerated by SEC.**
20. **Australia is very different and has continuous disclosure. Listed companies must disclose all price sensitive information as soon as practicable, subject to limited exceptions. This is intended to deprive insider information of that insider character. Information is not required to be disclosed under the continuous disclosure regime for as long as it is in fact confidential and meets one of the exceptions in the Listing Rules, for example it concerns an incomplete proposal or negotiation.**

BIOGRAPHY

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Donna M. Nagy is the C. Ben Dutton Professor of Law at Indiana University Maurer School of Law in Bloomington, Indiana, USA. She teaches and writes in the areas of securities litigation, securities regulation, and corporations, and recently served for six years as the law school's Executive Associate Dean. Her scholarship includes two co-authored books, one on the law of insider trading and a casebook on Securities Litigation and Enforcement. She has published extensively in distinguished law journals on matters including insider trading and fiduciary principles; government officials and financial conflicts of interest; and securities enforcement remedies. She is also a frequent speaker on securities regulation and litigation topics at law schools and professional conferences. Professor Nagy is a member of the American Law Institute and served as a member of the National Adjudicatory Council of the Financial Industry Regulatory Authority (FINRA) and as an appointed member to the ABA Corporate Laws Committee. She began her teaching career in 1994, and prior to that, was an associate with Debevoise & Plimpton in Washington, D.C. She earned her law degree in 1989 from New York University School of Law and her BA in Political Science in 1986 from Vassar College.

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Dr Pamela Hanrahan is a lawyer, legal academic and author who specialises in corporate law, corporate governance and financial services regulation. She is Professor of Commercial Law and Regulation at the University of New South Wales Business School, a Senior Fellow of the Melbourne Law School, a member of the Centre for Law Markets and Regulation at UNSW, and an associate of the Centre for Corporate Law at the University of Melbourne. She is also a member of the Society of Investment Law (USA), a Fellow of FINSIA, a solicitor member of the Law Society of New South Wales and a former Regional Commissioner of the Australian Securities and Investments Commission. Pamela is a member of the Executive Board of the Business Law Section of the Law Council of Australia and a member of the National Corporate Governance Committee of the Australian Institute of Company Directors.

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Cases

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Legislation

***Corporations Act* 2001 (Cth)**

***Securities Exchange Act* of 1934**