Insider Trading:

Securities Act of 1934, Section 10(b)5 establishes notion of “securities fraud”

Cady Roberts (1961) 10(b)5 applicable to “insider” transactions. Insiders were officers, directors or holders of 10% or more of the stock. The case law established that for insider trading to exist:

- A relationship to an insider that conveyed inside information to a trader had to exist
- Such traders were obliged not to trade of this information until it had been disclosed publicly.

Texas Gulf Sulphur (1968)

- Court of appeals tightens standards for insider conduct: purchase based on any possible price sensitive information that is not known to the public after a reasonable period of time to absorb the information has passed is consider a violation of 10(b)5
- Raises question of whether or not economic analysis of the costs and “benefits” to be realized by insider trading should justify its prohibition.

Chiarella (1980) Case of a printer (a “tippee”) who discovered information about pending merger deals and traded on it: He was convicted but his case was overturned by the Supreme Court:

- A tippee can “inherit” insider information (and the fiduciary duty that comes with it), but held that Chiarella was too far removed from the original duty to have inherited it, and
- To breech the duty, the tippee must engage in “manipulative or deceptive practices” (which Chiarella had not)
- However, a dissenting opinion held that the information itself was “property” belonging to the company and in misappropriating it, Chiarella should have been guilty of 10(b)5

SEC Rule 14(e) – 3a

-- SEC promulgates this rule to establish that anyone directly or indirectly “misappropriating” inside information thereby commits a “manipulative and deceptive” act.
March 6, 1973  Dirks receives information from Secrist, former officer of Equity Funding
Dirk’s visits company, concludes there were bogus transactions on the books
Dirks advises clients to sell stock. Price is 28 5/8
March 21, Dirks contacts LA Times reporter to give the story. Paper does not write about it, instead notifies SEC about Dirks.
March 27 Dirks requested to meet with SEC; NYSE halts trading in EF at 14 3/8.
March 28, SEC suspends trading in EF, orders investigation into Dirks for insider trading.
Apr 2, WSJ article appears based on Dirks findings
NYSE files charges against Dirks for “spreading rumors and inside information.”
August 1976, SEC charges Dirks and his clients with violating Section 10(b) of the Exchange Act of 1934, and SEC Rule 10(b)5 by repeating the inside allegations of fraud to client.
  o  “Tipees” must either publicly disclose or refrain from trading.
  o  Because of Dirks’ role in uncovering the fraud it “only” censured him.
  o  Dirks was outraged and pursued the case
    ▪  Appeals court ruled the fiduciary obligation of insiders pass to those to whom the inside information passes
    ▪  Dirks had obligation to refrain from trading until the matter became public
July 1983, Supreme Court rules against appeals court and vindicates Dirks.
  o  Two elements must exist to have a 10(b)5 violation:
    ▪  A relationship that enables someone to “tap into” the protected inside information of a company.
    ▪  So becoming an insider, the information has to be capable to materially affecting prices so as to make trading on it unfair.
  o  However, the Supreme Court also said that a duty to refrain or disclose does not arise unless there is an independent “fiduciary relationship” with the company, which Dirks was deemed to have had since his information came from a person who had obtained it on the inside. (If Dirks had discovered the information on his own he would not have been a tippee)
  o  AND, the “tippee” has to have made “secret profits” from the information (which Dirks did not)
Dennis Levine (1986-89) Investment banker who traded on merger inside information with funds being stashed in a Bahamian account of the Swiss Bank, Bank Leu.

- 1985 Levine revealed after anonymous tip to Caracas office of Merrill Lynch. Followed by pressure of the Swiss to breech bank secrecy rules
- Levine cooperates with the SEC and givers up the “Yuppee Five” (deal lawyers and bankers that fed information to Levine), and prominent arbitrageur Ivan Boesky (Boesky is fined $100 million by SEC and agrees to jail term)
- Boeskey gives SEC Martin Siegel (MD at Kidder Peabody) and Michael Milken.
- Siegel gives up Robert Freeman (Partner at Goldman Sachs) and two more junior men at Kidder Peabody. Siegel pays $4 million and goes to jail.
- Freeman is charged with insider trading, fights charges for 2 ½ years then aggress to confess one count of “mail fraud” for which he was sentenced to pay a fine of $1 million and go to jail for 4 months.


- Based on testimony of Levine, Siegel and Boesky and independent research, the SEC and the Justice Dept charged Drexel and Milken of a variety of infractions:
  - Drexel was also threatened with RICO charges; it plead guilty, was fined $630 million, and went bankrupt.
  - Milken was the principle dealer in junk bonds and used his ability to make markets in the bonds to provide financing for large new issues for companies that were otherwise unlikely to have access to such credit (including Enron in early 1980s) and for individual “raiders” and “takeover specialists” to finance large hostile takeover bids. Milken himself made more money from all this that Drexel did – in 1990 he was thought to be worth several billion.
  - Milken was defiant and fought the government’s charges against him vigorously.
    - The government charged him with 98 counts of violations of 10(b)5 – market manipulation, stock parking, disclosure fraud and insider trading.
    - Milken finally decided to plead guilty to six felony counts, was fined and sued for damages totally about $1 billion and was sentenced to 10 years in jail – he served less than 3 years.
Lessons Learned:

- The law may still be less clear than many would like it to be – there is room for further review of some of the central principles (such as SEC Rule 14(e)-3a and others) and Supreme Court reviews have led to reversals before.
- But, none of the insider trading cases of the 1990s established new legal grounds – none went to trial or were reviewed by appeal courts. All were the subject of plea bargains.
- Once the SEC or the Justice Department is after you, whether you are innocent or not, they have all the power and your life is rapidly headed toward ruin!
- The SEC and NYSE watchdog capabilities have increased considerably via technology upgrades.
- Accused persons almost always reveal and testify against their former colleagues and accessories (it is almost impossible to commit insider trading all by yourself – anyone else who becomes involved will probably tell on you if they are brought in for questioning).
- Federal sentencing guidelines (and other penalties) have been tightened – sentences are harsher than before. The SEC can be very nasty when pursuing insider trading investigations as it appears to have wide public support to attacks on greedy Wall Streeters, etc.
- It is very difficult to argue that insider trading might be worth the risk.
- If it happens now, it is most likely the result of ignorance or carelessness.
- In late March 2002, Goldman Sachs was notified that the SEC may bring charges against it for alleged violations of insider trading rules in the government bond business in October 2001.