INSIDER TRADING: WHERE IS THE LINE?

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Following the contours of the Securities and Exchange Commission’s seminal Cady, Roberts opinion in 1961, the federal courts developed the law of insider trading in two reasonably clear and predictable molds. Corporate insiders will incur liability for trading on material nonpublic information in breach of the duty they owe their corporations and shareholders, and corporate outsiders will be liable if they misappropriate and trade on such information in breach of a duty they owe to the source of their information.

Recent cases have blurred the lines of liability for insider trading. Courts now may impose liability on defendants in situations where it is unclear whether they assumed any duty to the corporation or other source of their information, where the information in question is vague or speculative in nature, and where it is unclear that they acted with the requisite mental state. Compounding this uncertainty, the SEC and the Justice Department have made insider trading a high prosecutorial priority and are expending substantial resources and using new tools to bring insider trading cases that would not have been pursued in earlier times.

Faced with uncertain liability parameters and intense enforcement efforts, prudent traders may conclude that any trade based on significant nonpublic information is just too risky. A wrong guess on any duty, materiality, or scienter element—finally resolved years later on appeal—can lead to imprisonment, or at least heavy civil fines, and a ruined career. Yet such a determination not to trade on significant nonpublic information effectively pushes these prudent traders into a so-called “parity-of-information” regime, in which all significant information must be publicly disclosed before it can be used for trading. While Congress, the SEC, and the courts have consistently rejected parity of information as an explicit legal requirement, the European Union’s enforcement model specifically embraces parity.

The SEC and DOJ commitment to insider trading enforcement is to be commended for promoting fair markets for both ordinary and sophisticated investors, and thus for encouraging capital formation and economic growth. But it is an enforcement program that can be enhanced—and a parity regime avoided—through clear definition of the elements of the offense, through good case selection, and through alternative disposition paths to fairly and efficiently resolve smaller and less clear cases.

I. INTRODUCTION

“This is a case of first impression and one of signal importance in our administration of the Federal securities acts.” With those words just over fifty years ago in Cady, Roberts, a Securities and Exchange Commission (“SEC”) administrative proceeding, Chairman William L. Cary began the first insider trading decision ever issued under the federal securities laws.

The vast majority of insider trading cases over the decades following Cady, Roberts have adhered to Cary’s basic analysis. However over the last several years, the SEC and the

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1 Cady, Roberts & Co., Exchange Act Release No. 6668, 40 S.E.C. 907, 907 (Nov. 8, 1961). Cary was a leading corporate and securities law scholar, and was for decades the Dwight Professor of Law at Columbia Law School.

2 In situations defined in cases following Cady, Roberts, trading while in possession of material nonpublic information may violate Securities Act §17(a), Securities Exchange Act (“Exchange Act”) § 10(b), and Exchange Act
Department of Justice (“DOJ”) have pushed their insider trading enforcement programs in new and increasingly aggressive directions. Where courts have agreed with the SEC and DOJ, this has resulted in new, and sometimes expansive and unpredictable takes on the familiar elements of duty, materiality, and scienter laid out by Cary. These cases on the cutting edge point to where the law of insider trading is likely headed over the decade ahead. But as discussed below, they have also created uncertainty as to where the line of liability presently exists.

Part II examines how the SEC and DOJ have pushed to significantly expand the basic elements of insider trading in recent cases. Next, Part III discusses how the risks arising from this expansion have been substantially magnified by the government’s recent intense focus on investigating and prosecuting insider trading, as well as by the new electronic and other investigative tools now available to the government.

Part IV then considers how, without a bright line delineating what is right and wrong, there is real prospect that careful traders—seeking to manage this uncertainty as to the metes and bounds of insider trading liability—may find themselves adhering to a “parity-of-information” approach long ago rejected by the Supreme Court but embraced in Europe. Finally, Part V suggests a number of ways to assure fairness in the handling of insider trading matters in this new environment, including increased clarity in articulating the elements of the offense, good case selection and more flexibility in the means for resolving such cases.
