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SEC Adopts New Rules on Insider Trading

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The SEC has adopted new rules to “clarify and enhance” the law of insider trading. In addition, in spite of strong criticism from a variety of market participants, the SEC has adopted Regulation FD (Fair Disclosure) in response to concerns about selective disclosure of material nonpublic information to securities analysts, institutional investors and others.

The SEC, by its rulemaking, formally adopted:

- a general principle of insider trading liability that imposes liability on persons who trade while “aware” of material nonpublic information. Rule 10b5-1 also establishes three affirmative defenses to liability where a trade resulted from a pre-existing plan, contract or instruction that was made in good faith. The rule represents the SEC's response to the unsettled issue of whether a defendant in an insider trading action must be shown to have *used* inside information, or merely to have traded while *in possession* of inside information.

- the position that the “misappropriation” theory of insider trading can be applied (under Rule 10b5-2) in the following circumstances:

  - when a person agreed to keep the challenged information confidential;

  - when the people involved in the communication had a history, pattern or practice of sharing confidences that resulted in a reasonable expectation of confidentiality; and

  - when the person providing the information was a spouse, parent, child or sibling of the recipient, unless it could be shown that there was no reasonable expectation of confidentiality.

- a regulation under the 1934 Act that requires domestic reporting companies that intentionally disclose material information to securities market professionals, or to holders of the issuer's securities under circumstances in which it is reasonably foreseeable that the holder will trade on the basis of the information, to do so through public disclosure, and to make prompt public disclosure of information whenever they learn that they “unintentionally” made material selective disclosure.

The new rules and the regulation take effect 60 days after publication in the *Federal Register*.

This memorandum summarizes the new insider trading rules. A separate memorandum is available summarizing Regulation FD.

1. Insider Trading

Neither the SEC nor Congress has expressly defined insider trading in a statute or rule. Instead, the law of insider trading has evolved on a case-by-case basis under the antifraud provisions of the 1934 Act, primarily Section 10(b) and Rule 10b-5. From the SEC's perspective, although the fundamental theories on which insider trading actions are based have been settled by the courts, courts remain divided over certain aspects of applying the theories. The SEC has adopted rules to address two areas of uncertainty.

(a) *Rule 10b5-1*

One of the two new SEC insider trading rules represents the efforts of the SEC general counsel to clarify the standard of liability that has been in flux as a result of inconsistent court decisions on the question of whether a defendant in an insider trading case must have *used*, not merely *possessed*, material nonpublic information to be liable under Rule 10b-5. The SEC rejected a straightforward "use" test as well as the more balanced "use" test with a strong inference of use from "possession." Instead, it adopted a rule that resembles the "knowing possession" standard set forth in a 1993 case, but has proposed balancing the rigidity of that standard by means of enumerated affirmative defenses.

The SEC has stated that as a general principle, insider trading liability will arise when a person trades while "aware" of material nonpublic information. This principle will apply to all theories of liability for insider trading, including classical insider trading (based on fiduciary duty), temporary insider status, tippee liability and misappropriation of inside information.

The general principle provides several exceptions from liability in situations where a person is not likely to have used the inside information: namely, where a trade resulted from a pre-existing plan, contract or instruction that was made in good faith. The affirmative defenses are intended to cover those situations where a defendant (an individual or entity) can show that the information possessed was not a factor in a trading decision, and include:

- a defense where, before becoming aware of material nonpublic information, a person entered into a binding contract to trade in the amount, at the price and on the date at which the trade was effected (*e.g.*, to carry out a pre-existing contract to buy or sell);

- a defense where, before becoming aware of material nonpublic information, a person had provided instructions to another to execute a trade in the amount, at the price and on the date at which the trade was effected (*e.g.*, to permit a trade to proceed based on instructions given to a broker at a time when the person had no inside information); and

- a defense where, before becoming aware of material nonpublic information, a person had adopted and previously adhered to a written plan specifying purchases or sales of securities in the amounts, at the prices and on the dates at which the person purchased or sold securities *(e.g.*, to permit regular, pre-established programs of purchases or sales).

In each of the above cases, whether by contract, instruction or plan, rather than showing that an amount, date and price were set for trades, a defendant can alternatively show that there was a written formula, algorithm or computer program for determining the amount, date and price for trades. Also, in each of the above cases, the defendant must show that (i) the contract, instruction or plan did not permit the person to exercise any subsequent influence on how, when or whether to effect the trade, unless the person exercising such influence was not aware of the material nonpublic information when doing so; and (ii) the trade occurred according to the contract, instruction or plan without deviation.

These contracts, plans or instructions must be entered into in good faith and not as part of a plan to evade the prohibitions of Rule 10b5-1. A person would lose the defense for a securities trade if the person enters or alters a corresponding or hedging transaction or position in respect of the trade.

The rule defines "amount" (a specified number of shares or other securities or a specified dollar value of securities), "price" (market price on a particular date or a limit price, or a particular dollar price) and "date" (a specific day of the year on which an order is executed or a day or days on which a limit order is in force).

The SEC cited various examples of how the rule might work. An issuer could implement a stock repurchase program that uses a written formula to derive amounts, prices and dates or the plan could delegate all discretion to determine amounts, prices and dates to a person who is not aware of inside information, provided the plan did not permit the issuer to exercise subsequent influence over purchases. An employee could acquire company stock through payroll deductions under a stock purchase plan or a 401(k) plan, by providing oral instructions as to plan participation or proceeding by means of a written plan. The transaction price could be computed as a percentage of market price, and the transaction amount could be based on a percentage of salary deducted under the plan. The date of plan transactions could be determined pursuant to a formula set forth in the plan. Alternatively, the date of plan transactions could be determined by a plan administrator, assuming that person is not aware of inside information at the time transactions are executed and the employee exercises no influence over the timing of the transactions.

The rule also provides an alternative defense for an institutional trader (*i.e.*, other than an individual) that can demonstrate that (i) the individual making the decisions on behalf of the entity to trade was not aware of inside information and (ii) the entity had implemented reasonable policies and procedures, taking into account the nature of the entity's business, to prevent insider trading (which policies and procedures may include restrictions on trading of securities as to which the trader has inside information or seek to prevent such individual from becoming aware of inside information).

(b) *Rule 10b5-2*

The Supreme Court in 1997 upheld the "misappropriation" theory of insider trading. Under that theory, a person commits insider trading by misappropriating material nonpublic information for securities trading purposes, in breach of a duty of loyalty and confidence. This duty may be inherent in certain business relationships (such as attorney-client relationships or employer-employee relationships). In non-business relationships (such as family and personal relationships), it is less clear when a duty of loyalty or confidence necessary to support a finding of misappropriation may arise.

To clarify the duty of loyalty and confidence in a non-business context, the SEC has ruled that a person can be liable under the "misappropriation" theory of insider trading (i) where the person agreed to keep the challenged information confidential (though the agreement need not be in writing); (ii) where the people involved in the communication had “a history, pattern, or practice of sharing confidences” (which need not be business-related) that resulted in a reasonable expectation of confidentiality or (iii) where the person providing the information was a spouse, parent, child or sibling of the recipient, unless it could be shown that there was no reasonable expectation of confidentiality. This non-exclusive definition will apply to both trading and tipping violations.

2. Impact

Reporting companies, as well as institutional traders, should review their insider trading policies and procedures in light of the new insider rules. Persons wishing to take advantage of Rule 10b5-1 by planning securities transactions in advance will need to be mindful of the advance planning requirements as well as the requirement to permit such pre-planned transactions to proceed without interference.

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The foregoing memorandum provides only a general overview of the SEC's new rules on insider trading. It is not intended to provide legal advice, and no legal or business decision should be based on its content.

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