Insider Trading

Trading by people who have access to material, non-public information that allows them to make a substantial profit by either buying or selling the company's securities (usually stock). Insider trading is strictly prohibited by securities law and violators are subject to large fines and jail time.

Summary Article: Insider Trading
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Insider trading of stocks and other securities has been the subject of federal and state oversight for many years. Since the 1930s, the U.S. government has sought to prevent this practice, which occurs when an officer, director, employee, adviser or large stockholder of a corporation buys or sells stock while in possession of non-public information. Insider trading, if successful, allows a person to reap a large profit or avoid a steep loss, depending on the type of information. Such was the case in the 1980s and 1990s when individuals such as Michael Milken and Ivan Boesky made hundreds of millions of dollars through insider trading. Because of such abuses, the purchase and sale of securities before a major corporate announcement is carefully scrutinized by government regulators.

The Securities Exchange Act of 1934 placed national regulations on the sale of securities, created the Securities and Exchange Commission (SEC) to oversee the regulatory process, and empowered the SEC to issue rules that spelled out in detail illegal practices, including insider trading. In addition, most states have insider trading laws and regulations as well. However, the SEC is the major regulator of insider trading. The main source of its policing authority is Rule 10b-5. This rule was originally limited to corporate officers but in 1961 the SEC broadened it to include anyone who trades in securities used nonpublic information.

A typical case of insider trading involves a corporate officer who learns that the company's earnings have declined. This will depress the value of the stock when the news is released to the public. The officer, who has thousands of shares of company stock that were obtained through a favorable stock option plane, sells some of these shares before the news is released. This is insider trading because it unfairly gives the office an advantage over all others who own the stock. During the late 1980s and early 1990s insider trading flourished as investment bankers negotiated large corporate mergers. Numerous prosecutions flowed from these transactions, netting corporate officers and employees but also investment bankers, stock analysts and some journalists who specialized in financial news.

For many years the Supreme Court limited the reach of Rule 10b-5 to those who had a fiduciary relationship to the corporation. Thus, a person who did have not this type of relationship and who obtained insider information could not be prosecuted for violating the federal regulation. The Court announced this rule in Chiarella v. United States, 445 U.S. 222, 100 S.Ct. 1108, 63 L.Ed.2d 348 (1980). In this case a person who worked in a printing shop obtained information from a corporate document he was printing and used it to purchase stock before a corporate takeover bid was announced. He realized a large profit from the transaction. Nevertheless, the Court stated that he had not violated the...
law and could not be prosecuted absent a duty to speak and that duty must arise from a relationship of “trust and confidence between the parties to a transaction.”

This case seriously weakened the insider trading rule. However, the government encouraged the lower federal courts to accept a theory of insider trading based on the misappropriation of confidential information.

The Supreme Court finally acknowledged and upheld the misappropriation theory in United States v. O’Hagan, 521 U.S. 642, 117 S.Ct. 2199, 138 L.Ed.2d 724 (1997). In July 1988, James H. O’Hagan was a partner in a prominent the Minneapolis, Minnesota law firm. In July, Grand Met, a British corporation, retained the firm as local counsel to assist it in the possible acquisition of Pillsbury, a U.S. corporation. O’Hagan did not work on the Grand Met initiative, but became aware of what was being contemplated. Beginning in August 1988, O’Hagan purchased 2,500 call options for Pillsbury stock with September, October, and November expiration dates. In September 1988, O’Hagan purchased 5,000 shares of Pillsbury common stock. On October 4, 1988, after Grand Met publicly announced its tender offer for Pillsbury stock, the stock went from $39 a share to $60 per share. O’Hagan soon exercised his options and then liquidated the stock along with his previously purchased common stock, realizing a profit of over $4.3 million. The SEC conducted an investigation into O’Hagan’s investment activities. He was indicted and later convicted on 57 counts of mail fraud, securities fraud, and money laundering. His conviction was based on the misappropriation theory of insider trading.

Using the misappropriation theory, the government contended O’Hagan, as a partner in the law firm retained by Grand Met, breached his fiduciary duties owed to his firm and Grand Met when he obtained confidential, material, non-public information regarding Grand Met’s interest in acquiring Pillsbury, and used that information to purchase Pillsbury securities. The Supreme Court held that a person who trades in securities for personal profit, using confidential information misappropriated in breach of a fiduciary duty to the source of the information, may be held liable for violating Rule 10b-5.

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