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Federal Securities Law: Insider Trading

Michael V. Seitzinger
Legislative Attorney
American Law Division

Summary

Insider trading in securities may occur when a person in possession of material nonpublic information about a company trades in the company's securities and makes a profit or avoids a loss. The Securities Exchange Act of 1934 and the Insider Trading Sanctions Act of 1984 have provisions which forbid insider trading. One provision of the 1934 Act requires the disgorgement of short-swing profits by named insiders. The 1934 Act's general antifraud provision has been used many times to sanction insider trading. In addition, in 1984 Congress enacted legislation imposing up to treble damages upon one who engages in insider trading.

Insider trading in securities may occur when a person in possession of material nonpublic information about a company trades in the company's securities and makes a profit or avoids a loss. Two federal statutes have provisions which forbid insider trading: the Securities Exchange Act of 1934¹ and the Insider Trading Sanctions Act of 1984.²

One provision in the Securities Exchange Act is specifically designed to discourage insiders in the corporation from taking advantage of their inside information in the trading of the corporation's securities. Section 16 of the 1934 Act³ places sanctions upon insiders who use inside information in making short-swing profits. For purposes of this provision, an insider is defined as any "person who is directly or indirectly the beneficial owner of more than 10 per centum of any class of any equity security...which is registered...or who is a director or an officer of the issuer." Every such person must file a report with the Securities and Exchange Commission at the time of the registration of the security on a national securities exchange or by the effective date of a filed registration statement or within ten days after he becomes a beneficial owner, director, or officer and within ten

¹ 15 U.S.C. §§ 78a *et seq.*

² P.L. 98-376, codified in a number of provisions of 15 U.S.C. §§78a *et seq.*

³ 15 U.S.C. § 78p.

days after the close of each calendar month if there has been a change in the ownership or if the person has purchased or sold a security-based swap agreement.⁴

To prevent the unfair use of inside information, section 16(b) permits the company or any security holder suing on behalf of the company to recover any profit which the person realizes from any purchase and sale or sale and purchase of any equity security of the company within a period of less than six months.

Section 10(b)⁵ of the 1934 Act and SEC Rule 10b-5⁶ have also been used in many cases of insider trading violations. Section 10(b) is the 1934 Act's general antifraud provision. Although it does not refer to specific types of fraud or to specific types of insiders, one of its most frequent applications over the years has been to insider trading. The statute states:

It shall be unlawful for any person, directly or indirectly by the use of any means or instrumentality of interstate commerce or of the mails, or of any national securities exchange:

(a)...

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

The Insider Trading Sanctions Act of 1984 was enacted because of the belief that

[i]nsider trading threatens...markets by undermining the public's expectations of honest and fair securities markets where all participants play by the same rules. This legislation provides increased sanctions against insider trading in order to increase deterrence of violations.

"Insider trading" is the term used to refer to trading in the securities markets while in possession of "material" information (generally, information that would be important to an investor in making a decision to buy or sell a security) that is not available to the general public.⁷

The Act provides that, if the Commission believes that any person has bought or sold a security while in possession of material nonpublic information, the Commission may bring an action in United States district court to seek a civil penalty. The penalty may be up to three times the profit gained or loss avoided.

⁴ 15 U.S.C. § 78p(a).

⁵ 15 U.S.C. § 78j(b).

⁶ 17 C.F.R. § 240.10b-5.

⁷ H.R. Rep. No. 98-355, at 2 (1984).

After a number of hearings and considerable debate in the 100th Congress, the President signed the Insider Trading and Securities Fraud Enforcement Act of 1988.⁸ This Act expanded the scope of civil penalties to control persons who fail to take adequate steps to prevent insider trading; increased the maximum jail terms for criminal securities law violations from five to ten years, with maximum criminal fines for individuals to be increased from \$100,000 to \$1,000,000 and for nonnatural persons from \$500,000 to \$2,500,000; initiated a bounty program giving the SEC discretion to reward informants who provide assistance to the agency; and required broker-dealers and investment advisers to establish and enforce written policies reasonably designed to prevent the misuse of inside information.

Among the regulations issued by the SEC which may concern insider trading, one in particular, Regulation FD,⁹ may be mentioned. Regulation FD, a relatively new disclosure rule, addresses selective disclosure. It provides that, when an issuer or any person acting on behalf of the issuer discloses material nonpublic information to certain enumerated persons (typically securities market professionals and holders of the securities), it must disclose that information to the public. The timing of the required disclosure depends upon various factors which are discussed in the rule.

⁸ P.L. 100-704.

⁹ 17 C.F.R. § 243.100-243.103.