

What each Reporting Entity must understand about transactions based on the privileged information of companies listed

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Definition of Insider Trading

- ▶ Rule 10b5-1: **the purchase or sale of a security of any issuer, on the basis of material nonpublic information** about that security or issuer, in breach of a duty of trust or confidence that is owed directly, indirectly, or derivatively, to the issuer of that security or the shareholders of that issuer, or to any other person who is the source of the material nonpublic information

Some People Don't Think It Should Be Illegal

- Faster movement of information to the market
- Cheaper compensation for managers of companies
- Incentives to innovation

Insider Trading: Why It Is Very Bad

- ▶ Actually creates disincentive to share information with the market
- ▶ Defeats Transparency
 - ▶ A Central tenet of the market is that all investors have parity of information
 - ▶ Undermines price integrity of securities market
- ▶ Heads I win, tails you lose – Unfair to the trading counterparty and investors as a whole
- ▶ Increased cost of capital as a result of investors losing confidence in the market

FATF considers Insider Trading a Predicate Crime for Money Laundering

“FATF’s definition of the “designated offences: that lead to money laundering include three securities-specific offenses: insider trading, market manipulation, and fraud.”

Chapter 4 of FATF/GAFI October, 2009 Report ***Money Laundering and Terrorist Financing in the Securities Sector***

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What may be material, non-public information?

Hypothetical Examples:

- Earnings Announcements
- News regarding contracts
- Results of drug studies
- Research and Development results
- Mergers and Acquisitions
- Significant Financial Changes (new debt et cetera)
- The launch of a new product
- (This list is **NOT** exhaustive)

What is material?

- *"..would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available" Basic v. Levinson, 485 U.S. 224, 231-32 (1988)*

Classical Theory of Insider Trading

- Insider
 - Permanent or Temporary
- In possession of material non-public information
- Trades securities
 - Use of information vs. Possession of information
- With the necessary intent
 - Mental state involving intent to deceive or defraud (knew or had reason to know, or recklessly disregarded the fact, that the information was confidential)

Misappropriation Theory

- Applies to outsiders
 - Not employees of issuer
- Who learn the material nonpublic information, and
- Who owe a duty to someone other than the issuer not to use the information for their personal benefit
 - Pre-existing relationship of trust and confidence
 - E.g., attorneys, investment bankers, advisers, family members, contractors

Other “Who” Concepts

- Tipper Liability
 - Insider who shares nonpublic material information in breach of a duty and receives a personal benefit
- Tippee Liability
 - Person who received the material nonpublic information who knew or should have known that the information was relayed in a breach of duty of trust and confidence
 - Provides a benefit to tipper
 - See *Dirks v. SEC*, 463 U.S. 646, 653-54 (1983)

What about.....

➤ **Scenario 1**

- While eating lunch at a restaurant, Jesus G overhears some strangers in a booth next to him talk about an upcoming merger. Jesus calls his broker after lunch and buys the stock of the target company.

➤ **Scenario 2**

- Angelina R, while working at a bank, learns that a listed company is seeking a large loan from the bank because it is having liquidity issues. She calls her broker and buys put options on the large company.

Issuers and Insider Trading

An Inspiration for a section of the Exchange Act of 1934 – Albert H. Wiggin



Albert H. Wiggin was a Hero

- ▶ Born in 1868 to a family of modest means
- ▶ After high school, he worked as a “runner” hand-delivering messages for bankers
- ▶ He quickly moved up the ranks – becoming a vice president by age 36 at Chase National Bank and a few years later the CEO and Chairman of the Board of Chase National Bank.
- ▶ Under his leadership bank deposits grew from \$91 million to more than \$2 billion. Part of his success was the opening of a securities division.

[Fair To All People: The SEC and the Regulation of Insider Trading \(The Securities Exchange Act of 1934 - Principles of Full Disclosure\) | Galleries | Virtual Museum and Archive of the History of Financial Regulation \(sechistorical.org\)](#)

Albert H. Wiggin was a Hero

- ▶ On October 24, 1929, the Dow Jones Industrial Average dropped by 11% during intraday trading
- ▶ Wiggins immediately stepped in
 - ▶ He and two other Banking executives stepped up and put in a dramatic bid to buy 25,000 shares of US Steel at \$205 – way above the market price.
 - ▶ The action rallied the market and the Dow Jones was only down by 6.38% at the close of the day
- ▶ He made the cover of Time for being such an excellent representative of his profession

Or was he?

- ▶ The heroics weren't enough to save the stock market
- ▶ With the stock market's crash, the Great Depression began
- ▶ Congress wanted answers to what caused the stock market crash and initiated what became known as the Pecora Investigation
- ▶ The Pecora Investigation found that Wiggin was not harmed by the stock market crash.
- ▶ Starting in September, 1929, more than a month before Wiggin's heroic act on the NYSE, he began selling short, through hidden transactions, more than 40 shares of his own company – he made around \$4 million
- ▶ And that was perfectly legal.....

The Wiggin Provision – Section 16 of the Securities Exchange Act of 1934

- It shall be unlawful for any such beneficial owner, director, or officer, directly or indirectly, to sell any equity security of such issuer if the person selling the security does not own the security sold.....

Don't Insiders Usually Have Insider Information? – Can They Ever Buy/Sell Their Stock?

- ▶ **Rule 10b5-1 of the Securities Exchange Act of 1934** offers corporate insiders a way to transact in company stock over a predefined period of time, even if the insider becomes aware of material, nonpublic information during the transaction period, as long as the transaction is done according to a pre-existing plan that was established when the insider was not aware of any material, nonpublic information.

SEC Allegations of Insider Trading re: Cavco Industries, its CEO, and CFO

The SEC's complaint alleged that:

- ▶ Cavco Industries, Inc. was having merger discussions with Skyline Corp.
- ▶ Joseph Stegmayer, the Cavco CEO, caused Cavco to purchase shares of Skyline
- ▶ Skyline ultimately merged with another company, but that announcement raised Skyline's stock price by 48% giving gains of \$260,000 for Cavco
- ▶ SEC sent a subpoena to Cavco regarding the trading.
- ▶ Stegmayer then sold 11,000 shares of Cavco that he personally owned
- ▶ When news of the SEC investigation came out, Cavco stock plummeted by 23%, sparing Stegmayer a \$880,000 loss

The relief agreed to with the SEC:

Stegmayer consented to (subject to court approval) a permanent injunction, a bar for serving as an officer or director of a public company for 5 years and a civil penalty of \$1.48 million

<https://www.sec.gov/files/judg21-cv-01507stegmayer.pdf>

Insider Trading by a Corporate Entity?

What is the SEC allegation regarding CAVCO's Liability?

Internal Accounting Controls

- ▶ The SEC's complaint alleges that Cavco violated Sections 10(b) and 13(b)(2)(B) of the Securities and Exchange Act of 1934 ("Exchange Act") and Rule 10b-5 thereunder, because:
- ▶ Cavco failed to devise a system of internal accounting controls sufficient to provide reasonable assurance that its securities trading would be executed in accordance with its board's authorization, its corporate investment policy, and its securities trading policy

Internal Accounting Controls

- The SEC further alleges that Stegmayer circumvented and/or failed to implement the few controls that were in place by causing Cavco to trade in shares of Skyline and of other companies that Cavco was interested in acquiring, all without board knowledge.

Restrictions on Issuer Communications around an IPO

Section 5 of the Securities Act of 1933 requires companies to file a registration statement with the SEC before they may offer securities for sale. Companies may not actually sell the securities covered by the registration statement until the SEC staff declare the registration statement effective.

<https://www.sec.gov/education/capitalraising/goingpublic>

Restrictions on Issuer Communications around an IPO

- Quiet Period (pre-filing period)
- Waiting Period (registration period)
- Post-Registration Period

[Quiet Period | Investor.gov](#)

The Quiet Period

- ▶ Begins when the company decides to begin the IPO process (generally when it hires an underwriter)
- ▶ Continues until a registration statement is filed with the SEC
- ▶ All communications constituting an offer of the securities is illegal
- ▶ All actual sales of the security is illegal
- ▶ A company CAN communicate, just not about the offering for the 30 day period leading up to the initial filing



Waiting Period

Begins when the company first publicly files a registration statement with the SEC and ends when the SEC declares the registration effective

- Oral Communications constituting an offer can be made
- Written or electronic communications by means of a statutory prospectus with a bona fide estimate of the IPO price range
- No actual sales can be made

Post Registration Period

- ▶ Very similar to the Pre-Registration Period, except now actual sales can be made

Communication Rules around IPOs

The rules were NOT created to deal directly with Insider Trading

The rules help to create a level playing field in terms of information availability

Potential Strategies for Issuers:

- ▶ Complying with laws regarding insiders trading in their company's stock
- ▶ Safeguarding information
- ▶ Training employees regarding their obligations
- ▶ Monitoring/approving trading activity of "insiders" and others with access to the material non-public information

Potential Strategies for Issuers

- Adequate corporate governance and accounting controls
- Observing quiet, waiting and post registration requirements
- Memorializing the requirements in appropriately detailed policies and procedures
- Following the policies and procedures

Gatekeepers and Insider Trading

Accounting Firm (KPMG) Partner Shares Insider Information with Golfing Buddy



- ▶ Scott London shared insider information over the course of 18 months with his golfing buddy, Bryan Shaw, after Shaw's jewelry business began to falter.
- ▶ Shaw traded a dozen times on tips regarding upcoming mergers and just before earnings announcements, grossing more than \$1.2 million

[SEC.gov | Scott London et al.](#)

[Central District of California | Former Senior Audit Partner At KPMG Charged With Insider Trading | United States Department of Justice](#)

Shaw made nearly \$192,000 on his trades in RSC Holdings in advance of a merger

MOUNTAIN STATES | MOUNTAIN STATES CONSTRUCTION NEWS

United Rentals Acquires RSC Holdings for \$4.2 Billion

January 4, 2012



United Rentals Inc. and RSC Holdings Inc. recently announced that they have entered into a definitive merger agreement under which United Rentals will acquire RSC in a cash-and-stock transaction valued at \$18 per share, or a total enterprise value of \$4.2 billion, including \$2.3 billion of net debt. The boards of directors of both companies have unanimously approved the proposed transaction and recommended that their respective stockholders approve the proposed transaction.

The proposed transaction will create a leading North American equipment rental company with a more attractive business mix, greater scale and enhanced growth prospects. The combination is also expected to accelerate United Rentals' growth with industrial customers as well as provide a lower cost base and a less volatile revenue profile to better position the company through all phases of the business cycle.

Regulators/FBI noted Shaw's trading luck



When questioned, Shaw acknowledged that he had been getting information from London and had given him in exchange a Rolex and cash.

The FBI secretly recorded Shaw and London's conversations and snapped photos of Shaw giving London an envelope full of cash

London Paid Consequences

- ▶ Fired by KPMG (there goes a \$900K salary!)
- ▶ Sentenced to 14 months in federal prison
- ▶ Ordered to pay a \$100,000 fine by federal judge
- ▶ Settled with the Commission. Agreed to:
 - ▶ Cease and desist from causing any violations of Sections 13(a), (14(a) and 14(c) of the Exchange Act and Rules 13a-1, 13a-13, 14a-3 and 14c-2 and Rule 2-02(b)(1) of Regulation S-X
 - ▶ Denied the privilege of appearing or practicing before the Commission as an accountant

Shaw also Paid Consequences

- Sentenced to 5 months in prison
- Settled with the SEC to pay \$1.9 million – disgorging the illegal profits and a civil penalty

Potential Strategies for Gatekeepers

- Safeguarding information
- Training employees regarding their obligations
- Monitoring/approving trading activity of persons with material non-public information and others with access to the material non-public information
- Memorializing the requirements in appropriately detailed policies and procedures
- Following the policies and procedures

Broker-Dealers and Insider Trading

Potential Strategies for Broker-Dealers

Know your Customer

- Are they an Insider of a public company?
- Are they someone likely to be able to gain access to insider information at a public company?
- If an insider, do they have a board-approved plan for sales of their shares?

Potential Strategies for Broker-Dealers

Monitor Trading

- Special emphasis on accounts of those which may have material non-public information
- Review any and all trades or deposits of securities made by an insider
- Report any transactions which appear suspicious to FIU

FATF Indicators of Insider Trading – 2009 report

- ▶ The customer makes a large purchase or sale of a security, or option on a security, shortly before news is issued that affects the price of the security;
- ▶ The customer is known to have friends or family who work at or for the securities issuer;
- ▶ The customer lives in the locality where the issuer is located;
- ▶ The customer's purchase does not correspond to his or her investment profile. For example, the customer may never have invested in equity securities, but does so at an opportune time;
- ▶ The customer's account is opened or significantly funded shortly before a purchase; and
- ▶ The customer sells his or her position in a security in conjunction with a significant announcement about the security.

Potential Strategies re: Analysts/Research Activity/Investment Banking?

- Automated systems within investment banking to limit information access to approved deal members
- Prohibiting or Strict controls around remote log-ins
- Disabling the ability to download information to removable storage
- Physical separating trading activity from other firm activities

Broker-Dealer and Investment Banker: Strategies Often Used to Prevent Insider Trading

Firm Employees

- ▶ Identify all securities which the firm potentially has insider information regarding – keep the list on a need to know basis and keep it updated
- ▶ Compare all trading against the list – investigate anomalies

Firm Employees

- ▶ Require all employees which may come into contact with insider information to have all securities transactions approved in advance (and their spouses, minor children, trusts) – it may come from their other activities like serving on another company board

Broker-Dealer and Investment Banker: Strategies Often Used to Prevent Insider Trading

Firm Employees

- ▶ Consider limiting securities accounts to only those held at the firm
- ▶ Get copies directly from any other institution where securities accounts are held

Firm Employees

- ▶ Have policies and procedures outlining details including consequences of violations (including termination)
- ▶ File Suspicious Activity Reports and/or contact regulator with material violations

Other Entities That May Have Access to MNPI May Need to Consider Policies and Procedures re: the MNPI

- Traditional Banks
- Printers
- Outsourced services such as Information Technology/Janitorial Services
- ??????

Quiz Question #1

Which could be considered non-public information?

- A. Earnings Announcements
- B. Your Passcode to Your Bank Account
- C. Mergers and Acquisitions
- D. Failed Research and Development Tests
- E. What the CEO of a company eats every day for lunch
- F. Any information that a reasonable investor believes would move the market

Quiz Question #2

Can company insiders buy and sell stock in their own company?



Quiz Question #3
Only Company Insiders and Investment Bankers can Insider Trade

TRUE



Quiz Question #4

Entities likely to have material non public information may need to consider:

- A All of the below
- B Monitor and pre-approve trading of relevant employees
- C Allow employees to trade using it as a way to cheaply increase their compensation
- D Develop systems to safeguard that information

