CLIENT ALERT:
SEC Adopts New Rules on Insider Trading

August 2000

On August 10, 2000, the SEC adopted two new rules, Rule 10b5-1 and Rule 10b5-2, which are designed specifically to clarify unsettled issues in insider trading law and which will be effective on October 23, 2000.[1] Rule 10b5-1 imposes insider trading penalties if the trader is aware of material nonpublic information without requiring a showing that the trader has used the information. Rule 10b5-2 extends insider trading penalties to trading on the basis of material nonpublic information if (i) the recipient has expressly agreed to maintain confidentiality, (ii) the recipient knows or reasonably should know that the disclosing person expects the information will remain confidential or (iii) the disclosing person and the recipient have a family relationship, even in the absence of some other duty of confidentiality.

Insider trading has not been expressly defined by any statute or rule; rather, insider trading law has developed on a case-by-case basis under the antifraud provisions of the federal securities laws, primarily Section 10(b) of the Securities Exchange Act and Rule 10b-5. The new rules are intended to address two issues on which the courts have disagreed: (i) whether insider trading liability depends on a trader's "use" or "knowing possession" of material nonpublic information and (ii) when disclosure to family members or others with non-business relationships to the disclosing party may give rise to liability under the misappropriation theory of insider trading.

Rule 10b5-1: Trading "On the Basis Of" Material Nonpublic Information

The SEC has taken the position that a trade is on the basis of material nonpublic information if the trader "was aware of" the information when he or she made the purchase or sale. Based on the assumption that "awareness" of the inside information inevitably leads to use of the information, the general rule adopted by the SEC is that knowing possession provides a sufficient basis for liability.

Affirmative Defenses Against Liability

The SEC has adopted affirmative defenses by which a trader can establish that a purchase or sale was not made "on the basis of" information. One such affirmative

[1] See Securities and Exchange Commission Release No. 33-7881, 34-43154, IC-24599 (available August 10, 2000).

defense covers situations in which a person can show that the information he or she possessed was not a factor in the trading decision. To avail oneself of this affirmative defense, the person must demonstrate (1) that before becoming aware of the information, he or she entered into a binding contract, adopted a written plan or provided instructions on how to execute the trade; (2) that the contract, plan or instructions either expressly specified the amount, price and date, provided a written formula to determine such information or did not permit the person asserting the defense to exercise any subsequent influence over how, when or whether to effect the trade and (3) that the actual trade occurred pursuant to such contract, plan or instruction.

An additional affirmative defense is available to an entity that can demonstrate (i) the individual(s) making the decision on behalf of the entity was not aware of the inside information and (ii) the entity had implemented reasonable policies and procedures to prevent insider trading.

Rule 10b5-2: Duties of Trust or Confidence in Misappropriation Insider Trading Cases

In the new Rule 10b5-2, the SEC lists three sets of circumstances in which a family or other non-business relationships creates a "duty of trust or confidence" that would be breached by the disclosure of material, nonpublic information and would give rise to liability under the "misappropriation" theory of insider trading under Section 10(b) of the Securities Exchange Act and Rule 10b-5 thereunder. The misappropriation theory is used by the SEC when the disclosing or trading party owed no duty to the issuer to which the nonpublic information relates but “misappropriated” the information from the source of the information in breach of a duty of confidentiality to the source of the information. For example, the misappropriation theory was used to prosecute an attorney who “misappropriated” information about a proposed tender offer from the acquiring party, a client of his firm.

The three circumstances the SEC lists as creating a duty of trust or confidence are:

- Whenever a person agrees to maintain information in confidence. The Rule does not require either a written or an express confidentiality agreement.

- When a past history, pattern or practice of sharing confidences exists between two parties such that the party receiving the information knows or reasonably should know that the disclosing party expects the information to remain confidential.

- When the disclosing party and the receiving party have a spousal, parent-child or sibling relationship. Although this is a bright line liability rule for certain enumerated close family relationships, it does allows for an affirmative defense.

Affirmative Defense for Family Relationships

An affirmative defense is available to the family member receiving or obtaining the information if he or she can demonstrate that under the facts and circumstances of that particular family relationship, no duty of trust or confidence existed. To avoid liability under Rule 10b5-2, the family member receiving or obtaining the information must establish that he or she neither knew or reasonably should have known that the disclosing family member expected the information would be kept confidential because of the parties' history, pattern or practice of sharing confidences, and because there was no agreement or understanding to maintain the confidentiality of the information.

For Additional Information

If you have any questions about the legal ramifications of these new rules, please contact the following:

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