INSIDER TRADING UNDER THE FEDERAL SECURITIES LAWS[1]

An Overview for a Diversified Financial Services Company Compliance Program

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The stock market crash of 1929 and the ensuing Great Depression prompted Congress to pass extensive legislation to regulate the securities industry and to prevent the recurrence of a national economic crisis. Specifically, Congress passed the Securities Exchange Act of 1934 ("Exchange Act") with the goal of promoting fairness and integrity in the securities markets. With respect to insider trading, the primary concern is that the integrity of U.S. securities markets will be impaired if there is a perception that certain persons trading in securities have an unfair informational advantage over other persons. Consequently, federal securities laws generally prohibit "insiders" from benefiting from information that is not available to the investing public. It should be noted, however, that federal securities laws do not mandate that participants in public markets have equal information; rather, such laws focus on the fact that certain persons may use their position to obtain an unfair informational advantage over others.

The basic prohibition on insider trading under federal securities law is derived from Rule 10b-5, promulgated pursuant to Section 10(b) of the Exchange Act[2]. Specifically, Rule 10b-5 provides that:

> 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 facility of any national securities exchange,
>
> (a) to employ any device, scheme, or artifice to defraud,
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> (b) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading, or
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> (c) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

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[2] Section 10(b) under the Exchange Act has been described as "a catch-all provision 'to deal with new manipulative [or cunning] devices.'" *Ernst & Ernst v. Hochfelder,* 425 U.S. 185, 203 (1976) (quoting hearings on H.R. 7852 & H.R. 8720 before the House Committee on Interstate & Foreign Commerce, 73rd Cong., 2d Sess. 115 (1934) (remarks of Thomas G. Corcoran)).

While neither Section 10(b) nor Rule 10b-5 actually refer to insider trading, the Securities and Exchange Commission ("SEC") and federal courts have developed a substantial body of law interpreting such provisions to establish a basic prohibition against "insiders" engaged in buying or selling securities while in the possession of material non-public information. Over the last 25 years, the general prohibition against insider trading has been subject to an increasingly expansive interpretation by the SEC and federal courts, increasing the classes of persons and types of activities within its purview.

Under the Exchange Act, the SEC has jurisdiction to pursue violations of Section 10(b) and Rule 10b-5, including insider-trading violations. Additionally, in 1984, Congress passed the Insider Trading Sanctions Act ("ITSA"), which allowed SEC to obtain treble monetary damages against inside traders. In 1988, Congress passed the Insider Trading and Securities Fraud Enforcement Act ("ITSFEA"), which (i) expanded the definition of "controlling persons," to provide an incentive for organizations to internally police potential insider trading activities among its employees, (ii) imposed an affirmative duty on broker-dealers and investment advisors to maintain reasonably effective written compliance programs, (iii) codified a private right of action for “contemporaneous traders,” (iv) increased penalties for all Exchange Act violations, and (v) permitted the SEC to pay bounties to persons who provide information about inside trading.

Based on the foregoing, the SEC and the federal government take insider trading very seriously, and are vigilant in pursuing violations. As the securities markets become more dynamic, it is increasingly important for persons involved in the financial services industry to understand the expanding definition of insider trading and to be extremely careful to avoid a violation. The purpose of this paper is to provide the reader with an overview of insider trading, including (i) the basic elements of a violation, (ii) specific issues related to diversified financial services companies, (iii) the consequences of a violation, and (iv) methods utilized by the SEC to detect a violation of insider trading laws. This paper does not address certain ancillary matters such as short-swing profit liability, market manipulation or other misuses of material information.

In the ordinary course of business, employees of your companies or your clients will likely obtain material non-public information regarding advisory clients or other public companies. Therefore, it is critical that such employees have a basic understanding of insider trading laws and the consequences of a violation. Although not directly addressed by this paper, it is also very important that employees have a basic understanding of their employer's policies and procedures regarding insider trading, including the duty of access persons to report transactions, the code of ethics, the protection of confidential information, and the other matters which should be set forth in an effective Compliance Manual.

I. Insider Trading - Basic Elements of a Violation.

As stated above, the traditional violation of insider trading law involves the purchase or sale of securities by an "insider" while in the possession of material non-public information. The following discussion addresses the basic elements of such a violation. This section will also address tipper/tippee liability.

1. Definition of an Insider.

The basic principle that trading on inside information violates Rule 10b-5 as well as a test for determining who is an "insider" were established in *In re Cady, Roberts, Inc.*[3] and later expanded in *SEC v. Texas Gulf Sulphur, Co*.[4]

Based on *Texas Gulf Sulphur* and several other cases, federal courts and the SEC have developed a definition of the term "insider" to include any person who, by reason of a fiduciary or confidential relationship to an issuer of securities, has access to non-public material information about that company. A traditional definition of an insider is a person who: (i) possesses inside information, (ii) knows or should know the information is non-public, and (iii) received the information in his or her business capacity and for a legitimate business reason by virtue of a relationship giving access, directly or indirectly, to the information. Examples of corporate insiders might include:

- The issuing corporation itself, its directors, officers and employees, or major security holders;

- Outside professional advisors, including lawyers, accountants, brokers, dealers, financial and investment advisors as well as engineers;

- Business associates, including suppliers, customers, business partners, and parties to a proposed acquisition, divestiture or other transaction; or

- Financial analysts and institutional investors.

This list is necessarily incomplete because a person's status as an "insider" depends upon his or her relationship with the issuer. It should be noted that directors, officers, employees and controlling shareholders of publicly traded corporations or of a corporation negotiating a major transaction with a publicly-traded corporation, are, by the nature of their positions, usually deemed "insiders." The SEC, however, typically takes an expansive view of the definition of an insider, and has found that a large variety of persons can be insiders, including: accountants, bankers and lenders, brokers, business associates, competitors, corporate trustees, engineering advisers, escrow agents, family members, finders, institutional investors, investment advisers, investment bankers, lawyers, management consultants, marketing advisers, market makers,

[3] (1961) 40 SEC 907. The SEC found a violation of § 10(b) and Rule 10b-5 against a broker-dealer, one of whose partners was a director of a corporation, who sold a large number of the corporation's shares of stock upon receiving information from said partner-director that the corporation would shortly reduce the rate of dividends payable.

[4] (1968, CA2 NY), 401 F2d 833, 2 ALR Fed 190. The court affirmatively stated that Rule 10b-5 applies to anyone who, trading for his own account in the securities of a corporation, has access directly or indirectly to material information about the corporation intended to be available only for a corporate purpose and not for the personal benefit of anyone. The court further stated that anyone in possession of such material information must either disclose it to the investing public, or if he cannot disclose the information because of its confidential nature, abstain from trading or recommending the securities concerned while the inside information remains undisclosed. This finding is often characterized as the "disclose or abstain" rule.

merger and acquisition partners, subcontractors, printers, public relations advisers, registrar or transfer agents, security analysts, stock exchange personnel, testing laboratories, and underwriters. As discussed in subsection 5(a) below, both the recent adoption of the "misappropriation theory" by the United States Supreme Court both supports and codifies the SEC's expansive view of who an insider may be.

Finally, with respect to information obtained as an insider, an individual will remain an insider following the termination of his relationship with the issuer or source of information, and the individual should refrain from trading until such information becomes public.

2. <u>Inside Information</u>.

It is important to note that federal securities laws do not prohibit insiders from making trades. The prohibition only applies to the extent that the insider is in possession of inside information, which must be both material and not generally available to the public. To the extent that information is either immaterial or is publicly available, the insider is free to trade subject to other applicable securities laws.

(a) *Materiality Requirement.*

In determining what information should be considered material, federal courts and the SEC have established a very broad definition without reference to any specific dollar amount. Information is generally considered material if there is a substantial likelihood that a reasonable investor would consider it important in deciding whether to buy, sell or hold a security. Examples of material information include:

- Earnings estimates, or changes in previously announced earnings estimates;
- Significant expansion or curtailment of operations, the purchase or sale of substantial assets, significant new services or products, unusual borrowings or securities offerings;
- Significant merger, acquisition, divestiture or joint venture proposals or agreements and management reorganizations;
- Resignations of key executives, directors or accountants;
- Matters related to cash dividends, stock dividends or stock splits;
- Bankruptcy or other reorganization proceedings; or
- Material litigation or investigations by governmental agencies, including any settlement discussions.

Information can obviously be material if it will either have a positive or negative effect on the underlying company. For example, during the 1980s and early 1990s, insider trading cases typically focused on purchase transactions by insiders while in possession of positive information, such as pending acquisitions or joint ventures. In recent years, however, insider-trading cases have increasingly focused on sales transactions by insiders while in possession of negative information, such as investigations by governmental agencies or the fact that earnings estimates will not be satisfied.

Insiders should be very careful in examining whether certain non-public information is indeed material, as federal courts and the SEC are taking an increasingly expansive view of materiality. If there is a question regarding materiality, an insider should be educated to identify such situations and encouraged to consult with a compliance officer or inside counsel prior to undertaking any trading activities. The issue of materiality is always determined in hindsight, and if there is even a question, the prudent course for employees is to conclude that the information is indeed material, and refrain from trading (or tipping), or confirm otherwise with internal compliance personnel.

(b) *Non-Public Requirement*.

Since the purpose of insider trading regulation is to promote fairness in securities markets, the prohibition only applies to the extent that material information is not generally available to the public. Information is considered non-public if it has not been disseminated in a manner making it available to investors generally, and it remains non-public until there has been time for the information to have been absorbed. Such information may be made public through a press release or through the public companies various filings with the SEC, including its annual and quarterly reports and its proxy statements. Whether non-public information has become public or is sufficiently “absorbed” is difficult to determine, but generally requires at least 2 or 3 days in the public realm.

3. Prohibition against Trading.

To the extent that an insider is in possession of material non-public information, federal securities laws place an absolute ban on trading in the securities of the subject company. Such prohibition applies to buying or selling common stock, preferred stock, debt instruments, as well as options or any other derivative security. For example, if an insider is in the possession of material negative information regarding a company that is not publicly available, federal securities laws prohibit that person from selling the underlying securities or taking a short position in such security. It is also important to note that Rule 14e-3(a), promulgated under the Exchange Act, prohibits any person from trading on the basis of material non-public information regarding a tender offer, regardless of whether such person is an insider.

4. Prohibition against Tipping.

In addition to the basic prohibition on trading while in possession of material non-public information, federal securities laws also impose a prohibition on insiders providing "tips" to outside persons, often friends and family members. This is generally known as "tipping," which has been interpreted very broadly by both federal courts and the SEC. The restriction prohibits an insider (the "tipper") from disclosing to another person (the "tippee") (i) material non-public information regarding a public company, or (ii) making buy or sell recommendations regarding the securities of such public company. Further, this restriction prohibits the tippee from buying or selling securities based upon such inside information. In a typical tipping case, there is a long chain of both tippers and tippees. Under federal securities laws, both the tipper and the tippee may be liable for insider trading violations. This is true even if the tipper does not engage in any trading activity, and does not realize any financial gain from such information.[5]

People with access to material non-public information must be very careful when it comes to tipper liability. As set forth above, a tip does not need to be in the form of a specific buy/sell recommendation, but may also be in the form of disclosure of material non-public information to a tippee. Thus, to the extent that a corporate insider casually discloses material non-public information to a friend over dinner, and that friend subsequently trades in the subject securities, the insider may be subject to liability.

5. Recent Developments.

(a) *Acceptance of the "Misappropriation Theory"*

In *United States v. O'Hagan,*[6] the United States Supreme Court adopted the "misappropriation theory," which expands the scope of insider trading under Rule 10b-5 to include individuals known as "temporary insiders" who do not have a direct fiduciary duty to the respective public company or its stockholders. While the SEC and certain U.S. Circuit Courts had previously adopted and espoused the misappropriation theory, the *O'Hagan* decision resolved any doubt regarding such theory, which may now be used to expand the scope of persons subject to insider trading liability.

Under the classical insider trading theory discussed above, a person had to have some duty to the issuer of securities in order to be liable for trading (or tipping) based on material non-public information regarding such issuer. The SEC and other commentators, however, were concerned that this classical theory would allow trading by certain persons who have access to material non-public information based on their position but who may not have a direct fiduciary duty to the issuer (i.e. attorneys, accountants, underwriters, financial analysts, brokers, investment advisers and investment bankers). Such persons are typically referred to as "temporary insiders," and the SEC was concerned that insider trading by temporary insiders could adversely affect public confidence in securities markets. In certain instances, the SEC

[5] In *SEC v. Grossman et al.,*CCH Fed. Sec. Law Rep., ¶ 99,518, S.D.N.Y., No. 87 Civ. 1031 (May 6, 1997), Grossman passed on confidential, non-public information to friends and relatives who then made substantial ($1.5 million) profits by investing based on the information. Grossman was imprisoned and the court later found against him for $2.5 million including pre-judgement interest. The court held that "Grossman [is] jointly and severally liable for profits of [his] tippees," despite the fact that Grossman argued that he did not personally profit from the unlawful trading of the tippees.

[6] 521 U.S. 642 (1997). Defendant James H. O'Hagan, a partner at the law firm of Dorsey & Whitney, received confidential information regarding a possible tender offer by a firm client, Grand Met, for the target company Pillsbury Madison. O'Hagan did not work for Grand Met, but he received the confidential information through the law firm. He purchased Pillsbury securities prior to the tender offer and then sold the securities once Grand Met publicly announced its tender offer. The sale of the securities earned O'Hagan a profit of over $4.3 million dollars. O'Hagan was arrested and charged with fifty-seven (57) counts of securities fraud, federal mail and wire fraud and money laundering.

attempted to fit such temporary outsiders within the classical insider trading theory, with mixed results. Therefore, the SEC and others have supported the misappropriation theory, which will hold a person liable for trading (or tipping) based on material non-public information to the extent that such activity breaches a duty to the source of the information (typically the employer).

Although the adoption of the misappropriation theory by the Supreme Court has been criticized by certain commentators, it should be recognized as a significant increase in the scope of insider trading laws and an affirmation of the SEC's past position. This development should also be seen as significant to your company's employees, who will typically be considered temporary insiders for purposes of federal securities laws.

(b) *Other Recent Developments*

Insider trading cases account for a large portion of the SEC's enforcement activities and, as stated throughout this paper, the SEC has been very aggressive in pursuing insider trading violations. Attached as Exhibit A is a summary of certain recent insider trading decisions.

II. Specific Issues Related to Financial Services Companies.

In the operation of a diversified financial services company, employees in certain divisions are frequently in possession of material non-public information regarding publicly traded companies, while employees in other divisions are constantly involved in trading activities or providing investment advice. This dynamic situation creates the potential for the abuse of inside information. To address this concern, the ITSFEA added Section 15(f) to the Exchange Act and Section 204A to the Investment Advisers Act of 1940 (the “Advisers Act”), which require registered broker-dealers and investment advisers to "establish, maintain and enforce written policies and procedures reasonably designed" to prevent insider trading. While the ITSFEA did not directly impose this obligation on investment companies, most have adopted similar policies and procedures due to the "tenor" of the ITSFEA as well as the existence of Rule 17j-1 of the Investment Company Act of 1940 (the “Investment Company Act”), which requires investment companies to adopt "a written code of ethics containing provisions reasonably necessary to prevent" violations of anti-fraud provisions.

Although neither Congress nor the SEC has established specific guidelines, the SEC has made it clear that it places a high emphasis on having such policies and procedures in place, and that it will make such procedures a focal point in its on-going inspection program for financial services companies. Thus, it is imperative for an integrated financial services company to have adequate policies and procedures to prevent insider trading. In establishing such policies and procedures, Section 15(f) of the Exchange Act and Section 204A of the Advisers Act require that each company must "take into consideration the nature of its business..." As a result, there are no industry-wide or accepted standards for what policies and procedures must be used; rather, each company must establish adequate safeguards in light of its own unique circumstances. There are, however, a number of useful measures utilized by a broad number of financial services companies. The following section will address certain such measures.

1. Compliance Procedures - Chinese Walls.

Most compliance policies and procedures utilized by financial services companies are designed to restrict the flow of material non-public information, and thus, are described as part of a "Chinese Wall." For example, Chinese Wall procedures would isolate an investment banking department from brokerage, investment advisory and other research departments, and would limit the flow of sensitive information on a need-to-know basis. While the SEC has not adopted specific guidelines for such procedures, it has identified the following four elements that it deems necessary for an adequate Chinese Wall: (i) control of interdepartmental communications, (ii) review of employee trading through the effective maintenance of some combination of watch, restricted and rumor lists, (iii) memorialization of these procedures and documentation of implementation efforts, and (iv) heightened review of proprietary trading while the company is in possession of material non-public information.[7] These four elements are discussed separately below.

(a) *Control of Interdepartmental Communications.*

According to the SEC Division Report, an adequate Chinese Wall program must have procedures in place to control communications among various departments of an integrated financial services company. One method of controlling communications is to impose some sort of physical barrier between departments. Such barriers could include (i) physically separating departments on different floors or buildings, (ii) restricting access to certain files, offices and computers through the use of passwords or other security methods, and (iii) the use of code names when discussing sensitive topics. Another important aspect of controlling interdepartmental communications is the delegation of such authority to a compliance or legal department, which would have responsibility of maintaining watch and restricted lists, reviewing employee trading and involvement in controlling the flow of information when different departments have a need to communicate with each other.

Although limiting the flow of information between departments may reduce exposure to insider trading risks, there will be times when such communication is necessary. For example, an investment banking department may require information from a research department in connection with a transaction. In order to avoid tipping liability, the employee within the research department will most likely be brought "over the wall" and become a temporary insider for purposes of that project. In that instance, the compliance or legal department would be involved in that decision and would maintain records to document the status of the temporary insider.

Related to the control of interdepartmental communications, the compliance or legal department will often have responsibility of reviewing research reports prior to publication. The concern is that a research report would be issued by a research department while another department is in possession of material non-public information, in which case the release of the

[7] SEC Division of Market Regulation, Broker-Dealer Policies and Procedures Designed to Segment the Flow and Prevent the Misuse of Material Nonpublic Information [1989-1990 Transfer Binder] Fed. Sec. L. Rep. (CCH), ¶ 84,520 (1990) (hereinafter "SEC Division Report").

report would be delayed. To limit the risk of liability the respective research analyst would likely be brought "over the wall," and would take measures to limit the analyst's comments about the respective company.

(b) *Trading Restrictions.*

According to the SEC Division Report, a Chinese Wall program should have some restriction on the ability of its employees to trade in, or make recommendations regarding, the securities of certain companies. Such restrictions may include (i) a requirement that all employees maintain trading accounts with that Company, (ii) a requirement that employees with outside trading accounts submit all trade confirmations or monthly account statements for review, (iii) a requirement that all trades by employees be pre-cleared (or that pre-clearance be required only for employees of particularly sensitive departments, such as investment banking), or (iv) a ban on trading in an issuer's securities within a certain time period following the release of a research report regarding a particular issuer (usually 2 or 3 days).

In addition to these general restrictions, financial services companies also typically develop lists of issuers about which the firm has, or is likely to have, material non-public information. These lists are generally broken-down between restricted lists, watch lists and rumor lists, and the SEC has indicated that a combination of these lists is a minimum element of an adequate Chinese Wall. The standard categories of lists can best be described as follows:

- <u>Restricted Lists</u>. A restricted list identifies issuers about which the firm has material non-public information. The financial services company then distributes this list to employees, and prohibits employee and proprietary trades in the securities of listed issuers, and employees from soliciting or recommending trades in such securities.

- <u>Watch Lists</u>. A watch list is similar to a restricted list in that it identifies issuers about which the firm has material non-public information. A watch list, however, is not distributed to employees; rather, the compliance or legal department uses it to monitor suspicious trades and to highlight possible insider trading violations. For that reason, the SEC considers a watch list a more effective component of a Chinese Wall.

- <u>Rumor Lists</u>. A rumor list is used in the same manner as a watch list, but is not limited to issuers doing business with the respective financial services company. Such a list would include the securities of issuers involved in a recently announced transaction or that are subject to rumors regarding a pending transaction.

(c) *Memorialization of Procedures and Documentation of Efforts.*

In the SEC Division Report, the SEC expressed its view that financial services companies must improve memorialization of their policies and procedures in order to have an effective Chinese Wall. Initially, this would require the formalization and consolidation of all firm policies and procedures regarding insider trading, as well as an organized program to educate and train personnel with respect to these policies and procedures. This element would also require that financial services companies maintain documents to support its compliance efforts, such as (i) copies of significant interdepartmental communications, (ii) past restricted, watch and rumor lists, and (iii) documentation regarding the investigation of any suspicious trades. To the extent that such documentation is not maintained, it is difficult to prove that the compliance efforts of the respective financial services company were adequate.

(d) *Heightened Review of Proprietary Trades*.

In the SEC Division Report, the SEC expressed its view that financial services companies must have a higher degree of review of proprietary trading while it is in possession of material non-public information. The SEC Division Report defined proprietary trading as "risk arbitrage, market-making and block trading."[8] The SEC's primary concern was clearly risk arbitrage, and it recommended that financial services companies not engage in such activities while in the possession of material non-public information. The SEC did not make specific recommendations regarding market-making activities. Most firms, however, do not place significant restrictions on market-making and block trading activities.

2. Investment Company Code of Ethics.

In 1970, Congress enacted Section 17(j) of the Investment Company Act, which authorizes the SEC to require investment companies (and their investment advisers and principal underwriters) to enact codes of ethics. In 1980, the SEC promulgated Rule 17j-1, which requires every registered investment company (and its investment advisers and affiliated principal underwriters) to adopt a written code of ethics, which contains provisions “reasonably necessary” to prevent insiders (defined in the rule as “access persons”) from engaging in fraudulent transactions. In promulgating the rule, the SEC intended to prohibit insiders from gaining a personal benefit from transactions in securities that are held by an investment company, are to be acquired by it, or are under consideration for acquisition or sale. The SEC also intended to prohibit insiders from using their position with an investment company to influence its trading strategy to benefit themselves, such as by causing the investment company to buy, sell, or hold a security that the insider holds in his or her personal portfolio.

Rule 17j-1 also states that investment companies, investment advisors and underwriters enacting the codes of ethics “shall use reasonable diligence, and institute procedures reasonably necessary, to prevent violations” of such codes. Thus, codes of ethics must contain provisions addressing enforcement by the person or entity enacting such code.

In addition to self-enforcement, the SEC uses its enforcement authority to patrol compliance systems.[9] As seen *in First Investors* and *Alliance Capital*, many ethics codes, and

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[8] See SEC Division Report.

[9] In *First Investors Management Company, Inc.*, Advisers Act Release No. 1316, Investment Company Act Release No. 18,779, 51 SEC DOCKET 1520 (June 12, 1992) (settled), the SEC sanctioned First Investors for failing "to use reasonable diligence and to institute procedures reasonably necessary to prevent violations of [the firm's] code of ethics." Specifically, a large number of the reports that access persons in the portfolio department were required to file with the firm were filed late, several by more than a year. More recently, in *Alliance Capital Management LP*, Advisers Act Release No. 1630, 64 SEC DOCKET 1276 (Apr. 28, 1997) (settled), the SEC sanctioned the advisor's failure to give personal trades an appropriate level of review. Although the firm had a written code of ethics in place, it did not "effectively conduct the limited review mandated for itself." The SEC found that this deficiency constituted a failure to supervise within the meaning of the Advisers Act.

their enforcement, are deficient. Deficiencies can arise when a code is not kept up-to-date with the fund's corporate or other changes, when it is written in such a way that access persons cannot determine their responsibilities, or when it lacks appropriate enforcement mechanisms.

3. Personal Transaction Reporting.

Employees of securities firms must disclose their personal securities transactions to their employer, which in turn allows employers to prevent trading abuses. Specifically, Rule 17j-1(c) under the Investment Company Act requires investment company access persons to file reports disclosing various transactional details about all securities transactions in which they have a personal beneficial interest. The required reports are filed with the access person's employer, and once filed, must be retained as a required record of the firm. Such reports are filed on a quarterly basis, and are due within ten days of the close of the calendar quarter in which the trades took place.

To provide investment advisers with similar information, Rule 204-2(a)(12) under the Advisers Act requires registered investment advisors to collect and retain reports of personal securities transactions by themselves and their "advisory representatives." Much like access persons, advisory representatives are defined to include the adviser's officers, directors, employees and other insiders. Finally, if an advisory representative is also an access person to a registered investment company, his or her reports under Rule 204-2(a)(12) will also satisfy the requirements of Rule 17j-1.

Broker-dealers are not subject to a specific SEC rule requiring personal transaction reporting. However, as previously noted, the SEC has interpreted Section 15(f) of the Exchange Act to require, at a minimum, reasonable procedures for periodically reviewing employee and proprietary trading accounts for evidence of misuse of material non-public information.

Since the information disclosed in personal transaction reports should play an important role in monitoring employees for abusive trading, the SEC has paid careful attention to compliance with these requirements. The SEC has brought enforcement actions against firms that have failed to institute adequate procedures and use reasonable diligence to promptly collect the reports required by Rules 17j-1 and 204-2(a)(12).[10]

4. Application to a Diversified Financial Services Company

While the purpose of this paper is not to discuss the internal compliance policies and procedures utilized by any particular company, most have established a program for addressing insider trading concerns. All employees should be familiar with the various provisions of the Compliance Manual, including policies on insider trading, the code of ethics and other compliance procedures. To the extent that an employee has a question regarding any such matters, it should be directed to the Compliance Officer.

Set forth below are a listing of what I would identify as the “hot points” for ongoing consideration in connection with existing internal compliance activities and programs. Although

[10] *See id.*

I am confident that much of it is old hat to you, Items 4(h) and 4(i) referencing a Global Oversight Committee is one of the more recent mechanisms utilized by financial services companies in monitoring internal compliance affairs.

(a) *Watch/Rumor Lists.*

Upon review of many policies of financial services companies, it is typical that a restricted list of securities in which an employee may not trade is maintained. It is often the case, however, that neither watch nor rumor lists are used at all.

- A "watch list" is similar to a restricted list in that it includes companies about which the firm may have material non-public information. A watch list, however, is not broadly disseminated to employees, and employees are not prohibited from trading in such securities. The purpose of a watch list is to assist the compliance department in monitoring suspicious trading activities, highlight potential insider trading violations and to determine whether "Chinese Walls" are effective. Most companies place an issuer on the watch list whenever the company is in a position to receive confidential information, and moves the issuer to the restricted list when the company is actually engaged to provide services.

- A “rumor list” is very similar to a watch list. Like a watch list, a rumor list is not disseminated to employees and is used primarily to detect possible insider trading violations. The issuers included on a rumor list, however, are generally not limited to issuers doing business with the company. Rather, a rumor list covers issuers that are involved in a recently announced transaction or are subject to rumors regarding a potential transaction.

(b) *Physical Barriers.*

There should be physical barriers to restrict the flow of interdepartmental communications. Examples of such physical barriers include:

- Placement of different departments on separate floors or buildings, and when possible, limiting the transfer of personnel from one department into another. Also restricting directors, officers and key employees from serving dual roles in more than one market sensitive area.

- Procedures to restrict access to computers, files, internal reports and offices. This can be done through password protection, locks, maintenance of separate accounting systems, records and support staff and other security measures.
- Use of code names or words when referring to sensitive topics or to identify sensitive documents. Also employing secure filing systems, and restricting access by persons in a department where breaches of confidentiality could likely occur.

- Limiting attendance at meetings where sensitive topics will be discussed.

(c) *Active Role of Compliance Department.*

The compliance department should be actively involved in implementing any compliance program, including maintenance of restricted and watch lists, monitoring trading activity, reviewing any research reports and controlling any interdepartmental communications. The established procedures and systems should be reasonably expected to prevent and detect, insofar as practicable, any violations of insider trading rules and regulations.

(d) *Update Compliance Policy.*

While most financial services companies have a comprehensive written compliance policy, it is necessary to constantly monitor any developments in federal securities laws, and amend or supplement the policy as necessary to ensure continuing compliance. The company should then promptly communicate any such changes or supplements to employees. A policy cannot be effective unless it is up to date; this is why procedural deficiencies often arise with out-of-date policies.

(e) *Document Compliance Efforts.*

It is of utmost importance that compliance efforts are adequately documented. This responsibility should normally rest with the compliance department, which should ensure that all significant measures are recorded and that the records are consistent, complete and non-duplicative.

(f) *Continuing Education.*

The continuing education of employees regarding federal securities laws and internal policies is a crucial element of a compliance program. This would include educational programs during orientation periods for new employees, as well as periodic training, seminars and memoranda to reinforce existing policies and to update employees with respect to recent developments. Most importantly, a training program should include specific guidance to employees on how to respond to specific situations, such as inquiries from outsiders reporting suspected violations and avoiding the risk of tipping material non-public information. The process for reporting violations is paramount because employees must be able to report without fear of retribution. Thus, a company must establish a system that employees know how to use and feel comfortable using.

(g) *Specific Policies for Directors and Officers.*

The federal securities laws place certain restrictions on the conduct of officers and directors with respect to their securities transactions. The compliance department should seek to provide guidance to such persons. All officers and directors should consult with the compliance department prior to purchasing or selling securities. The policies for officers and directors should provide a more detailed treatment for the prohibitions on insider trading than the policy provided to other employees. For example, the policy may provide examples that such officials will be more likely to encounter than the average employee.

(h) *Global Oversight Committee.*

In a multi-service firm a Global Oversight Committee should be established to conduct the centralization, monitoring and interpretation of firm-wide policies. This committee should be independent of and oversee the compliance department of each organization. This committee can act as intermediary between business units to avoid breaches of physical barriers and resolve potential conflicts.

(i) *Internal Controls/Audits.*

The Global Oversight Committee should establish procedures to supervise the compliance department through surprise reviews or audits. The internal audits will test the effectiveness of the procedures in place. The audits conducted by the Global Oversight Committee should also include a frequent review of the expertise, training and qualifications of all compliance personnel. The Global Oversight Committee should also be responsible for periodic reviews of the overall trading across company lines to detect any suspect patterns of trading which may be indicative of insider trading, such as common links in trading positions which might suggest trading decisions based on material non-public information or a breach of the company's internal procedures. Additionally, the compliance department should also have surprise audits and other procedures in place to ensure compliance and prevent breaches of physical barriers.

(j) *Public Disclosure Procedures.*

The compliance program should address procedures that control public disclosures made by company employees. These procedures should minimize the risk that officers, directors or employees tip confidential material information to outsiders when fielding inquiries from persons outside of the company. Companies should consider distributing a concise policy to all personnel instructing them to refer all queries related to non-public information to a designated officer or spokesperson. In conjunction with the above policy, an information officer should be designated, or a group of persons, to be responsible for the preparation and dissemination of unstructured public disclosures. Implementing detailed procedures that will guide the information officer should also be considered. Selective disclosure of material information should be avoided.

(k) *Special Precautions in Dealing with New Technologies***.**

The existence of the Internet, the installation of corporate web pages, the use of bulletin boards and newsgroups, and the increasing corporate use of e-mail are developments which warrant special attention because they exacerbate even further the difficulties in preventing the misuse of inside information and therefore multiply the opportunities for liability. This is specifically true because employees tend to be less concerned with the legal implications of their actions in response to or in delivering electronic communications. They must understand that the penalties are the same and that, in fact, the "technology trail" is usually easier to detect than a "paper trail." It is important that all employees understand that cyberspace abuses are simply the same abuses of the past in a different medium. Thus, they are punishable by the existing rules and regulations.

III. Consequences of a Violation.

As set forth above, insiders and tippees who trade securities while in the possession of material non-public information can be subject to liability for insider trading. Furthermore, persons who provide tips may also be subject to liability for insider trading even if the tipper did not actually engage in any transaction. The following section addresses the consequences for such a violation. Since deterrence is a primary objective of insider trading laws, the consequences of a violation are severe.

1. <u>Actions by SEC or other Federal Agencies</u>.

The SEC and other federal agencies and departments have several means of enforcement of insider trading restrictions. The statutory basis of all such remedies are set forth in the Exchange Act and are discussed briefly below.

(a) *Civil Penalties.*

Pursuant to Section 21A of the Exchange Act, federal courts may impose civil penalties of up to 3 times the profits made or losses avoided from insider trading. In addition, for controlling persons, Section 21A of the Exchange Act provides civil penalties of up to the greater of $1,000,000 or 3 times the profits made or losses avoided from the insider trading activities. Civil penalties are in addition to any disgorgement of profits or criminal penalties that may be imposed on a person violating insider trading laws.

(b) *Criminal Penalties.*

Section 32 of the Exchange Act provides, with certain exceptions, for criminal penalties up to a maximum of $1 million ($2.5 million for corporate entities) and 10 years imprisonment for each willful insider trading violation.

(c) *Injunctions and Equitable Relief*.

Section 20(d) of the Exchange Act authorizes the SEC to seek injunctive relief if it reasonably believes that a person "is engaged or about to engage in practices constituting" insider trading. This would prohibit an insider from engaging in future violations of securities laws, which is sought in almost every case brought by the SEC. In addition to injunctive relief, the SEC may seek other equitable remedies, such as remedial changes in personnel and organization of a controlling person. The most significant equitable remedy available to the SEC, however, is the disgorgement of profits gained or losses avoided as a result of insider trading. It is important to note that disgorgement is sought in almost every action brought by the SEC, and is in addition to any other criminal or civil remedies.

(d) *Administrative Disqualification.*

In addition to the remedies discussed above, in certain circumstances the SEC may bar persons found guilty of insider trading from acting as an officer, director, employee or affiliate of a broker-dealer, investment adviser or investment company.[11] Thus, if an employee of a financial services company is found guilty of insider trading, that person will likely be unable to work within that industry in the future.

2. Private Causes of Action.

Private parties can pursue their rights of action under Section 20A of the Exchange Act, which was added by the ITSFEA. Previously, a private plaintiff had to prove that he or she relied on the fraud or misrepresentation (including an omission) by the insider, which fraud actually caused the damage to the plaintiff. This requirement established a very high standard of proof for the private plaintiff and greatly inhibited the ability to recover damages. Section 20A, however, now allows private citizens to claim damages without proving actual reliance on the fraud caused by the insider. Under Section 20A, a cause of action is available for a person who traded the same class of securities "contemporaneously" with and on the opposite side of the market from a person engaged in insider trading. In these actions, the plaintiff may recover damages up to the profit gained or loss avoided as a result of the insider trading, minus the amount, if any, that such person was required to disgorge pursuant to an action brought by the SEC under Section 21(d) of the Exchange Act.

Private plaintiffs can also pursue actions against a violator under an implied right of action under Rule 10b-5, Rule 14e-3, or Exchange Act Section 14(e). The limitations on recovery imposed by Section 20A with respect to actions by "contemporaneous traders" (e.g., setoff for any monies disgorged pursuant to an SEC action) would not be applicable to these implied private actions.

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[11] See, for example, Section 15(b) of the Exchange Act (broker-dealers); Section 203(e) of the Advisers Act (investment advisers); and Section 9 of the Investment Company Act.

3. Liability of Controlling Persons.

Section 20(a) of the Exchange Act imposes joint and several liability on a person controlling a violator of the Exchange Act or its rules, unless the controlling person acted in good faith and did not directly or indirectly induce the violations. With the passage of ITSFEA, Congress added Section 21A to the Exchange Act, which essentially supplants Section 20(a) for purposes of imposing "controlling person" liability. Although "controlling person" is not defined in the new legislation, the legislative history makes clear that a "controlling person" may include not only employers, but any person with power to influence or control the direction or management of a person. A central component of ITSFEA was an effort to provide a greater deterrent to insider trading, and ITSFEA did this by expanding the scope of liability of "controlling persons" who fail to take adequate steps to prevent insider trading.

Section 21A of the Exchange Act sets forth a new expansive standard for finding "controlling person" liability. Specifically, under Section 21A(b)(1)(A), a controlling person may be liable for the insider trading violations of persons within its control if the controlling person "knew or recklessly disregarded the fact that [a] controlled person was likely to engage in the act or acts constituting the violation and failed to take appropriate steps to prevent such [violation]" or if the controlling person "knowingly or recklessly failed to establish, maintain or enforce [compliance policies and procedures] required under Section 15(f) of [the Exchange Act] and such failure substantially contributed to or permitted the occurrence of the [violation]."

Controlling persons could face criminal and civil penalties up to $1,000,000 ($2.5 million for corporate entities) or three times the profit gained or loss avoided for failing to take appropriate steps to prevent illegal trading or tipping by others Since controlling persons are jointly and severally liable with persons within their control, there is the potential of massive liability exposure for each insider trading violation by an employee or associated person.

4. Other Consequences of Violations.

In addition to the various penalties and damages discussed above, there are other significant consequences to an alleged violation of insider trading laws. For example, a person accused of an insider trading violation will likely be required to hire a lawyer and incur substantial legal fees in defending against the respective charges. Such legal fees will not be reimbursed even if the accused is vindicated of all charges. In addition, a person accused of insider trading will likely suffer personal embarrassment, and may even lose their job.

IV. Detection of Violations by SEC.

All persons with access to inside information should be aware that the SEC has very elaborate means to detect violations. A common mistake is for people to presume that the SEC only detects or prosecutes insider trading violations involving substantial sums of money, such as the high profile cases against Ivan Boesky or Michael Milkin. To the contrary, casebooks are full of examples in which regular people are prosecuted for making relatively minor trades on the basis of material non-public information. As discussed in the section above, the consequences for such a violation can be substantial.

1. SEC Information Gathering.

The SEC is quite inventive when it comes to information gathering regarding potential insider trading violations, and it uses several different methods, including the following.[12]

- Market Surveillance and sophisticated computer programs used by stock exchanges and other self-regulatory organizations that monitor unusual trading activities.
- Responses to inquiries from stock exchanges and other self-regulatory agencies regarding unusual trading activities.
- Investigations conducted by the SEC of other securities law violations, such as financial disclosure matters.
- Information exchange agreements with governments of foreign countries.
- Press and media sources.
- Anonymous tips.

2. SEC Bounty Program.

Congress and the SEC have established a bounty program to encourage private parties to disclose information regarding potential insider trading violations to the SEC. Section 21A(e) of the Exchange Act, added by ITSFEA, provides that up to 10% of the civil penalties imposed for an insider trading violation may be paid to the "person or persons who provide information leading to the imposition of such penalty." The award of such bounty is made in the sole discretion of the SEC and is not subject to judicial review. An award, however, may not be made to a member, officer or employee of the Department of Justice or a self-regulatory agency.

[12] *See* John F. Olson, Gerald T. Lins, Clark H. Nielsen and David L. Ratner, *Insider Trading: Background and Compliance*, C533 ALI-ABA 1267 (1990).

EXHIBIT A

Recent Judicial Developments in Insider Trading Law

A. *Financial Services Employees*

- SEC v. Bakrie, 98 Civ. 5570 (S.D.N.Y.), Lit. Rel. No. 15834 (Aug. 6, 1998)

On August 6, 1998, the SEC filed an insider trading action in the United States District Court for the Southern District of New York against Anindya N. Bakrie ("Bakrie"), a former junior financial analyst in the Global Power Group of Saloman Smith Barney, Inc. ("Salomon"). The SEC's complaint alleged that Bakrie, an Indonesian national, engaged in insider trading in a company that was involved in merger negotiations in which Salomon's Global Power Group was participating as an adviser. The SEC's complaint sought a permanent injunction against Bakrie for violations of the antifraud provisions of the Exchange Act and civil penalties.

The SEC's complaint alleged that Bakrie had learned through Salomon that a certain company was engaged in confidential merger negotiations with a potential acquirer and that a merger announcement was eminent. Bakrie, then asked his friend, Roy Handojo, to purchase common stock in this company on Bakrie's behalf and promised to share any resulting profits with Handojo. Several days after Handojo invested $650,000 to purchase the stock, Bakrie learned through Salomon that the merger was no longer likely, and told Handojo that he had changed his mind about purchasing the stock. Over the next two days, Handojo sold all of the stock, incurring a $13,869 loss. Three days later, the SEC filed an emergency civil action against Handojo concerning unrelated allegations of insider trading and he was arrested by the U.S. Attorney's office for the same conduct (*See* SEC v. Handojo below). Within a week after Handojo's arrest, Bakrie abruptly returned to Indonesia and resigned from Salomon.

Without admitting or denying the allegations of the complaint, Bakrie consented to the entry of a final judgment which permanently enjoined him from violating Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, and ordered him to pay a $40,000 civil penalty.

- SEC v. Handojo, 97-CIV-6805 (S.D.N.Y.), Lit. Rel. 15492 (Sept. 15, 1997); Lit. Rel. 15540 (Oct. 24, 1997); Lit. Rel. No. 15852 (Aug. 18, 1998).

On September 12, 1997, the SEC filed an insider trading action alleging that Roy Handojo, an Indonesian national and visiting analyst formerly employed in the Financial Institutions Group at J.P. Morgan & Co., Inc.'s New York office ("J.P. Morgan"), traded in the securities of five companies involved in four separate merger negotiations in which J.P. Morgan's Financial Institutions Group participated as an adviser. The complaint charged that in each of the merger transactions, Handojo purchased the securities days before the companies announced publicly that they had entered into definitive merger agreements.

The complaints alleged that Handojo violated Section 10(b) of the Exchange Act and Rule 10b-5 thereunder and sought injunctive relief, disgorgement, and civil penalties. On September 12, 1997, the Court ordered a temporary freeze of assets in Handojo's brokerage and bank accounts.

On August 18, 1998, Handojo, without admitting or denying the allegations contained in the SEC's complaint, consented to the entry of a final judgment which permanently enjoined him from violating the antifraud provisions of the Exchange Act. The final judgment also ordered him to disgorge the sum of $618,052 plus prejudgment interest of $36,571, which represents the total profits of his illegal trading.

- SEC v. Stricoff et al., 97 Civ. 8183 (S.D.N.Y), Lit. Rel. No. 15551 (Nov. 5, 1997).

The SEC filed an insider trading action against Alan M. Stricoff ("Stricoff"), a former compliance officer of Banker's Trust Securities Corp. ("Bankers Trust"), and four other individual defendants, alleging that they engaged in a scheme to purchase the securities of Caesars World, Inc. ("Caesars") just before the December 19, 1994 public announcement of ITT Corp.'s ("ITT") tender offer for Caesars. Bankers Trust served as a financial advisor to ITT in the tender offer, and its parent, Bankers Trust New York Corporation, served as ITT's investment banker. The complaint alleged that Stricoff learned of the proposed tender offer in the course of his employment and tipped the four other defendants, directly or indirectly, yielding profits for the defendants totaling $458,200.

The complaint alleges violations against each of the defendants Sections 10(b) and 14(e) of the Exchange Act and Rules 10b-5 and 14e-3 thereunder and seeks an order of permanent injunction, disgorgement, and civil monetary penalties. This case is pending.

B. *Tippee violations*

- SEC v. Lane et al., 97 CIV 8144 (S.D.N.Y.), Lit. Rel. 15549 (Nov. 4, 1997); Lit. Rel. No. 15801 (July 7, 1998).

The SEC filed an insider trading complaint against Andrew S. Lane and six other individual defendants, charging insider trading and/or tipping others to trade in the securities of the MEDSTAT Group, Inc. ("Medstat") in advance of a tender offer for Medstat by the Thomson Corporation ("Thomson"). The complaint alleged that Lane learned of Thomson's plans to acquire Medstat while working as the Director of Finance at a Thomson operating group. According to the complaint, Lane then bought a total of 3,000 shares of Medstat in a series of small purchases and tipped five of the other defendants; the sixth having received a tip from one of the other defendants. All but one of the defendants profited personally from the illegal trading in Medstat, the complaint charged. The complaint alleged further that on the direct or indirect recommendation of defendant Jack O. Scher, 37 persons purchased approximately 34,000 shares of Medstat. The complaint charged each of the defendants with violations of Sections 10(b) and 14(e) of the Exchange Act and Rules 10b-5 and 14e-3 thereunder.

Simultaneous with the filing of the complaint, without admitting or denying its allegations, six of the defendants consented to the entry of permanent injunctions and agreed to pay a combined total of over $888,000 in disgorgement, prejudgment interest, and penalties. On June 12, 1998, the remaining defendant, Tracy Ann Stoddart ("Stoddart"), consented to the entry of a final judgment by the United States Court for the Southern District of New York. Without admitting or denying the allegations in the complaint, Stoddart consented to an injunction against future violations of Sections 10(b) and 14(e) of the Exchange Act and Rules 10b-5 and 14e-3 thereunder, and agreed to pay $14,600.98 in disgorgement and $4,897.58 in prejudgment interest. The SEC's investigation of this matter is continuing.

- SEC v. Hirsch et al.

The SEC alleged that Susan L. Hirsch, a former senior account representative of Ruder-Finn, Inc. ("Ruder-Finn"), a public relations firm, obtained confidential information about Sandoz's confidential bid for GTI during the course of her employment at Ruder-Finn in advance of the Sandoz/GTI tender offer announcement. The complaint further alleged that Hirsch improperly passed the information to her brother, Gregory M. Hirsch, who tipped his friend Danny Kaminsky ("Kaminsky"), and then purchased GTI common stock and call options with Kaminsky in advance of the announcement for profits of $251,190. The Complaint further alleged that Gregory Hirsch and Kaminsky tipped Lewis A. Kooden, Daniel H. Klugman ("Klugman") and Michael A. Kooden, who purchased GTI common stock and call options for illegal profits of $43,795, $28,107 and $14,666 respectively.

On December 29, 1997, the Court entered final judgments against Susan Hirsch, Gregory Hirsch, Kaminsky, Lewis Kooden, Klugman, and Michael Kooden, permanently enjoining them from future violations of the securities laws and requiring them to pay, collectively, $604,704 in disgorgement, civil penalties, and prejudgment interest. The Defendants consented to the final judgments without admitting or denying the allegations against them.

- SEC v. Smirnoff

The SEC alleged that Susan S. Smirnoff, a senior vice-president of Ruder-Finn, obtained confidential information during the course of her employment in advance of the Sandoz/GRI tender offer announcement. The Complaint alleges that Smirnoff passed that information to her husband, Kirk I Zachary ("Zachary"), who purchased GRI call options a few days before the announcement. Simultaneous with the filing of the complaint, Smirnoff and Zachary consented, without admitting or denying the allegations of the complaint, to the entry of a final judgment of permanent injunction, requiring them to disgorge profits of $5,527 plus $728 in prejudgment interest, and to pay a civil penalty of $5,527.

C. ***Employee allegedly guilty of trading on confidential information learned through the course of his employment***

- SEC v. Schmidt and Whitehurst, Lit. Rel. No. 15352 (Apr. 29,1997).

On April 29, 1997, the SEC filed a complaint against David A. Schmidt ('Schmidt) and Willard A. Whitehurst ("Whitehurst") for insider trading in connection with their purchases, and those of Schmidt's tippees, of the common stock of Purolator Company ("Purolator") prior to the October 3, 1994 announcement of the merger between Purolator and Mark IV Industries Inc. ("Mark IV"). The complaint alleged that Whitehurst learned of the negotiations between Mark IV and Purolator by virtue of his employment with Dayco Products, Inc., a subsidiary of Mark IV. Whitehurst allegedly asked his son-in-law, Schmidt, to purchase $10,000 of Purolator common stock and tipped him about the negotiations. Schmidt then purchased 575 Purolator shares for Whitehurst and 4,325 for himself He also recommended Purolator to three persons who thereafter purchased a total of 10,273 shares. Following the public announcement of the merger, Whitehurst, Schmidt and Schmidt's tippees sold or tendered their shares for profits of about $109,483.

Simultaneously with the filing of the complaint, Schmidt and Whitehurst consented to the entry of permanent injunctions for violating the antifraud provisions of the federal securities laws. Schmidt agreed to a disgorgement of $105,241.99, plus prejudgment interest of $23,332.96, and a civil penalty of $68,206.93. Whitehurst agreed to a disgorgement of $4,240.62, plus prejudgment interest of $940.16 and a civil penalty of $19,826.56.

- SEC v. Soroosh, Civ. Act. No. C96-3933 VRW (N.D. Cal.), Lit. Rel. No. 15141 (Oct. 30, 1996); Lit. Rel. No. 15433 (Aug. 6, 1997), Lit. Rel. No. 15553 (Nov. 5, 1997).

On October 29, 1996, the SEC filed an insider trading complaint against Shahryar Soroosh. On August 5, 1997, the United States District Court of the Northern District of California issued an order holding that Shahryar Soroosh violated the federal securities laws by engaging in insider trading. The Court ordered Soroosh to disgorge $505,819.00 plus prejudgment interest. On October 31, 1997, the Court ordered Soroosh to pay a civil penalty of $160,000 and enjoined him from future violations of Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder.

The Court found that Soroosh, a former senior software engineer at Octel Communications Corporation ("Octel") amassed a substantial short position in the stock and options of Octel while in possession of material, non-public information concerning an Octel software delay. The delay was publicly announced on October 24, 1996. Upon the announcement, the price of Octel's common stock fell by over 35%, from $24.50 to $15.70 per share. As a result, Soroosh realized profits of over $500,000, based on his 35,000 share short position and his 80 put contracts, all of which he had accumulated in the weeks before the announcement. The SEC instituted its suit within days of the trading.

The Court rejected Soroosh's defense that his trading was part of a pattern of trading, finding that the trading at issue was out of the ordinary, and rejected his assertion that he did not possess material, non-public information. The Court concluded that Soroosh's "trading activity and the circumstances surrounding it were consistent with the possession of insider knowledge and he has offered no plausible explanation otherwise."

D. *Director allegedly traded and tipped regarding earnings below analysts estimates*

- SEC v. Johnson and Sanders, Lit. Rel. No. 15289, (N.D. Tex., Mar. 13, 1997).

On February 5, 1997, the SEC filed a civil action against Walter E. Johnson ("Johnson") and Rex E. Sanders ("Sanders") for insider trading in the stock of DF&R Restaurants, Inc. ("DF&R").

According to the complaint, Johnson was a member of DF&R's board of directors who, between November 5, 1994 and November 10, 1994, received material non-public information that DF&R's quarterly earnings would fall short of market expectations. On or before November 11, 1994, Johnson allegedly tipped Sanders, who sold 8,000 shares of DF&R stock at an average price of $26.625 per share on the morning of November 11, 1994, prior to DF&R's public announcement of deteriorating earnings. Following that announcement, the price of DF&R stock fell approximately 36 percent, to close at $17.75 on November 14, 1994.

Simultaneous with the filing of the Complaint, Sanders and Johnson consented, without admitting or denying the SEC's allegations, to be permanently enjoined from future violations of the antifraud provisions of the federal securities laws. In addition, Sanders was required to disgorge $79,000, plus prejudgment interest of $14,021.77, and Johnson and Sanders were each required to pay a civil money penalty of $79,000.

E. *SEC uses its power to "freeze assets" of alleged inside traders*

- SEC v. Certain Purchasers of Call Options of Duracell International, Inc., Civil Act. No. 96 Civ. 7017 (SAS) (S.D.N.Y.), Lit. Rel. No. 15045 (Sept. 16, 1996); Lit. Rel. No. 15250 (Feb. 10, 1997).

On September 16, 1996, the SEC filed this action against certain purchasers ("defendants") of call options of Duracell International, Inc. ("Duracell"). The complaint alleged that the defendants engaged in illegal insider trading prior to the public announcement on September 12, 1996 of a merger agreement between Duracell International and The Gillette Co.

According to the complaint, the defendants purchased "out of the money" September call options on September 10 and 11, 1996. In particular, the complaint alleged that the defendants purchased a total of 100 September 50 call options and 600 September 55 call options on those two days. The trades were allegedly conducted through Swiss and Bahamian accounts in a manner that concealed the beneficial owners of the trades. The complaint alleged that the defendants' trading resulted in profits of approximately $950,000. On the same day that the complaint was filed, the Court entered an order temporarily freezing the assets in the defendants' accounts attributable to the trading in the Duracell call options, requiring the defendants to identify themselves, allowing expedited discovery, and granting other relief.

On September 26, 1996, the Court held a hearing and entered a Preliminary Injunction against the defendants, who failed to appear at the hearing or to contest the SEC's action. The injunction, among other things, continues to freeze the assets in defendants' accounts attributable to the trading in Duracell call options.

On February 10, 1997, the SEC announced that it had obtained final judgments providing for the recovery of more than $1 million in illicit trading profits and the imposition of $1.77 million in civil penalties. The Court entered a final judgment against Lennox, S.A. ("Lennox"), a Swiss firm with discretionary trading authority over the Swiss account, permanently enjoining it from violation the antifraud provisions of the federal securities laws, and ordering a disgorgement of $450,698.83. Without admitting or denying the allegations of the complaint, Lennox consented to the entry of final judgment against it. With respect to the Bahamian account, the Court entered a final judgment by default against certain unknown purchasers, permanently enjoining them and ordering them to disgorge $603,275 in trading profits, and imposing a civil penalty of $1,770,000. The judgment will be satisfied in part from the trading proceeds previously frozen in the Bahamian account.

- SEC v. Certain Purchasers of the Common Stock of CBI Industries, Inc., 95 Civ. 9651 (MP) (S.D.N.Y. 1995), Lit. Rel. No. 15020 (Aug. 22,1996).

On August 22, 1996, the SEC announced that the United States District Court for the Southern District of New York entered final judgments by default against Ulbery Vermogensverwaltungs A.G. ("Ulbery"), Benjamin Weiss ("Weise"), Fasan Anstalt, Axteria Establishment, Anstalt Ducata, Anstalt Nifur, Gregory Stainow ("Stainow"), Domford Holdings Ltd., and Melilla Business Corporation in this insider trading case. The final judgments identify these individuals and entities as having effected, or caused to be effected purchases of the common stock of CBI Industries, Inc. ("CBI") in violation of the federal securities laws.

The complaint alleged that defendants made highly profitable purchases of CBI common stock just two days before Praxair, Inc. ("Praxair") publicly announced for the first time that it intended to commence a tender offer for the common stock of CBI. The Complaint further alleged that defendants purchased the subject CBI stock while in possession of material, non-public information concerning Praxair's impending takeover of CBI. In the aggregate, defendants purchased 114,000 CBI shares during the two-day period before Praxair's announcement, representing approximately 16% of the total volume of trades on those days.

On the same day that the Complaint was filed, the Court entered a Temporary Restraining Order freezing the subject CBI shares and any proceeds from the sales of the shares. On December 12, 1995, Judge Pollack entered a Preliminary Injunction continuing the asset freeze during the pendency of the proceeding. As a result of these Orders and two subsequent Orders, which had the effect of substituting cash for frozen CBI shares, in excess of $2 million was frozen and is presently held in the Court Registry Investment System ("CRIS").

The final judgment as to defendants Ulbery, Weiss, Fasan Anstalt, Axteria, Establishment, Anstalt Ducata, Anstalt Nifur, and Stainow provides for satisfaction of their disgorgement obligation from the frozen funds that are on deposit with the CRIS. The final judgment as to these defendants also imposes civil penalties in excess of $1.2 million to be satisfied from the frozen funds on deposit with the CRIS.