The Next Chapter in Insider Trading

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On June 30, the Ninth Circuit Court of Appeals handed down a decision in the SEC's case against J. Thomas Talbot, a lawyer, who had been charged with insider trading in violation of Rule 10b-5 under the Exchange Act. The Ninth Circuit held that Talbot could be found liable for insider trading under the facts presented by the SEC, reversing the lower court's contrary decision. This case provides some valuable insights for traders on the desk and their advisors.

It is my experience that most traders are baffled and terrified by insider trading. The doctrine is baffling because it is not always entirely clear to traders what is insider trading and what is not. Terrifying because the consequences of getting it wrong involve jail time. Most of us know someone who has enjoyed the hospitality of one of the many federal facilities that provide food and lodging to those who trade on material non-public information.

The cases interpreting Rule 10b-5 have attempted to distinguish between two different ways people obtain information about publicly traded securities, one of which is lawful and encouraged, while the other is unlawful and punishable by jail time. The person who researches companies may obtain information that nobody else has that gives her a leg up on other market participants. For example, by counting the number of trucks leaving the loading dock of a warehouse she may conclude that profits are up. No one else may know this. But, this is not what is meant by material non-public information. The information is, after all, publicly available to anyone willing to get up early and count trucks. She has done a socially useful thing, looking for evidence that suggests the market has undervalued or overvalued a security. When she puts her information to work, the stock will move in the direction of its true value. This sort of diligence is encouraged.

On the other hand, the director who learns at a board meeting that his company is going to acquire a competitor has not discovered this information through diligent research. Instead, the director received the information as a windfall because of his privileged position. Other market participants cannot acquire this information through diligent research because it is not publicly available. It is unfair and illegal for him to use this information to defraud other market participants.

To distinguish between these two situations, the courts have sometimes stated that illegal insider trading occurs when the person obtain information from his position as a fiduciary. The company director owes a fiduciary duty to his company not to misuse its secrets, while the diligent researcher has no such duty to the company owning the warehouse.

The Talbot case presents another way to acquire material non-public information. Nicholas Lebda, Lending Tree's CEO, told Brent Bickett, a Vice President at Fidelity National Financial, that negotiations were under way to acquire Lending Tree. Bickett told his CEO, William Foley. Fidelity owned 10% of Lending Tree; so, this was very good news. Foley announced this information at a Fidelity Board meeting that Talbot attended. Two days later, Talbot started buying Lending Tree stock.

Talbot wasn't a member of Lending Tree's board. He got his information because Lebda told Bickett, Bickett told Foley and Foley informed Fidelity's board. Talbot argued that since Fidelity did not owe any fiduciary duty to Lending Tree, he did not owe any fiduciary duty to Lending Tree and therefore could not be liable for insider trading.

The Ninth Circuit didn't buy this argument. Instead, the court pointed out that Talbot did owe a fiduciary duty to Fidelity, and he obtained the information about Lending Tree because of his relationship with Fidelity. By using the information to trade Lending Tree's stock, he was effectively stealing, or misappropriating, information that belonged to Fidelity.

It is much more likely that a trader will be in a position to misappropriate information than to receive it as a fiduciary. Relatively few traders are members of corporate boards where information useful in trading is likely to be presented. Many more traders know people who sit on corporate boards or who otherwise have some duty to keep information confidential. Sometimes, information slips out, and the temptation arises to use it illegally.

Material non-public information is the type of thing that falls off the back of the truck. It is stolen property, information that belongs to someone else. Its use leads down the primrose path to public disgrace, industry bars and jail time.

The first insider trading case was brought in 1944, shortly after Rule 10b-5 first appeared. Sixty years later, these cases still keep the SEC's Division of Enforcement working overtime.

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