Public Company Advocate April 20, 1998

NOTES FROM COUNSEL

Court disagrees with SEC position on insider trading

By Dana T. Ackerly II and Cara Maggioni, Covington & Burling, Washington, D.C.

A recent decision of the 11th Circuit Court of Appeals disagrees with the SEC’s approach to insider trading liability. What effect will the decision have on executives or directors who want to trade in their company’s stock?

A large majority of publicly traded companies adopt explicit “trading windows” of a few days each quarter as part of their insider trading compliance measures. Thus, executives or directors are prohibited from trading during relatively long “black-out periods” because they may be deemed to possess “material information” not available to the public, such as quarterly financial statements or corporate plans. Insiders with valid reasons or existing plans to trade are barred from doing so once a “black-out period” begins, even if the decision to trade is completely independent of the non-public information.

Questions raised

A recent decision by the U.S. Court of Appeals for the 11th Circuit may cause some companies to rethink these rules. At the very least, it raises important questions about arguments made by the Securities and Exchange Commission.

Although the underlying statute simply prohibits fraud or other deceptive practices, the SEC has taken the aggressive position that trading while in “knowing possession” of material non-public information is always unlawful.

The “use” test

In SEC v. Adler, the 11th Circuit held that the SEC’s “knowing possession” test is wrong. Instead, the court determined that an insider does not violate the law unless he or she actually “uses” the information in deciding to make a trade. The court concluded that this “use” test most accurately reflects the intent of Congress to prevent fraud and deception.

The facts of the case illustrate the important distinction that the court was making. Defendant Harvey Pegram, shareholder and former officer of Comptronix, attended a board meeting where an anticipated decline in sales was discussed. Five days later, Pegram began to sell 20,000 shares out of his total holdings of 869,897 shares of Comptronix common stock, all prior to the company’s public announcement of the expected decline in orders. Following the public announcement and drop in stock price, the SEC alleged that Pegram’s early sale avoided more than $17,000 in losses.

In his defense, Pegram maintained that the sales of stock were part of a pre-existing plan to raise money to purchase an eighteen-wheeler for his son’s business, which was delayed for a 120-day lock-up period following the company’s initial public offering. Pegram’s stockbroker testified to the plan, and Pegram had obtained approval for the sale more than a month prior to the sale. Thus, while Pegram clearly sold stock while possessing non-public information, there was a factual issue as to whether the information influenced the trades.

A second instance of alleged insider trading occurred when Pegram received phone calls from an officer of Comptronix who possessed material non-public information and shortly thereafter (within less than 15 minutes) proceeded to sell 150,000 shares of stock. Pegram contended that the sale was pursuant to a preexisting plan to diversify his portfolio as evidenced by similar large sales in the preceding two years, and that the timing of the plan was delayed due to the illness and death of a family member.

The 11th Circuit held that Pegram could not be guilty of insider trading unless the non-public information had a causal effect on his decisions. The court remanded the case for trial on this central issue, noting that this fact-intensive inquiry was appropriate for a jury, which would have to make judgments on the credibility of witnesses and explanations.

Inference of use arises

Importantly, the court acknowledged that an “inference of use arises from the fact that an insider traded while in possession of inside information.” Therefore, the court reasoned, the “use” test would not make it unreasonably difficult for the SEC to bring insider trading cases in the future. The fact that an insider uses non-public information would be presumed, but it would be a rebuttable presumption.
A word of caution

First, this area of the law remains unsettled. The opinion in Adler is based on the theory that there is nothing inherently fraudulent or deceptive in merely possessing non-public information. The court noted that existing Supreme Court opinions on insider trading, which address violations for trading on inside information or taking advantage of inside information, suggest that information must influence the decision for a violation to occur. However, the 11th Circuit’s view is not held unanimously by other courts. In fact, the few decisions that have discussed the issue to date reach conflicting conclusions.

Further, the SEC continues to maintain its position that the “knowing possession” test is the accurate interpretation of the law, and the Supreme Court has not yet resolved the matter. Thus, the decision represents “the law of the land” only in the three states encompassed by the 11th Circuit, Georgia, Alabama, and Florida.

In addition, the Adler decision relaxes the “knowing possession” test only to the extent of permitting the insider to rebut a presumption: i.e., that a person who has knowledge uses that knowledge when making an investment decision. In all but the strongest cases, it may be difficult for the defendant to prove otherwise.

Finally, and perhaps most importantly, the causal relation between “possession” and “use” is a question of fact that in virtually all cases will have to be determined by a jury. Thus, an insider who traded while “possessing” inside information would still be forced to undergo the expense and the strain of a trial to determine whether he or she actually “used” the information in making the investment decision in question. Regardless of the strength of the insider’s defense, the outcome of the case would be in no way assured, given the notorious unpredictability of juries.

For all these reasons, a corporation might readily decide that its “black-out period” measures should not be changed. The purpose of these measures is prophylactic: to protect executives and directors by eliminating any reasonable possibility that they might be charged with insider trading. A corporation may well decide that a stark prohibition against trading during certain periods of time is the only way to protect its insiders from any suspicion of improper trading.

Protective measures

While it may be premature to embrace a new era just yet, the Adler decision undeniably represents an important crack in the masonry of the SEC’s “knowing possession” test, and it is a development from which insiders may be able to benefit in close cases. Accordingly, executives and directors might keep in mind the following practical pointers:

1. Plan ahead. Individuals trading in their own stock should create a plan for future investment or divestment. Plans should be discussed, documented and implemented with stockbrokers and, potentially, legal counsel. Individuals should resist any temptation to expand or change existing plans following receipt of inside information.

2. Create contractual obligations. If possible, entering into executory contracts prior to receipt of inside information, e.g., agreement to sell or buy stock, could protect an individual from an inference of use, if information is subsequently received prior to the actual trade.

3. Maintain consistency. Maintaining a consistent pattern of trading may be persuasive to rebut an inference of influence. In particular, modest transactions, in relation to total holdings, may suggest transactions inconsistent with insider trading.

4. Document compelling reasons. An immediate and unexpected need to liquidate some holdings may provide a convincing rebuttal to the inference of use, for unusual or unexpected decisions.

5. Consider information received. Take good notes and carefully consider whether information received, whether at meetings or in consultation with colleagues, could be construed to influence a trading decision. Plan accordingly.

The ultimate effect?

The ultimate effect of the Adler decision remains to be seen. The SEC has indicated that it will continue actively to prosecute insider trading cases, and that it will advocate the “knowing possession” test in jurisdictions other than the 11th Circuit. Unless the other Circuits unanimously follow the 11th (which is unlikely), the Supreme Court will have to decide the issue eventually. Even if the “use” test becomes fully accepted, insiders will still face the very difficult, yet not insurmountable, burden of overcoming the adverse presumption recognized by Adler.

Governance Update

Last month, Notes From Counsel focused on investing in corporate governance audits. Shortly after the Association mailed the March newsletter, a “best practices” report, sponsored by Grant Thornton LLP, on the essential role of corporate governance systems in avoiding fraud and illegal activity was published by the National Association of Corporate Directors (NACD). The report highlighted low awareness among CEOs of regulatory and legal developments in this field and encouraged boards of directors to ensure that appropriate systems are in place to inform senior management and the board regarding corporate legal compliance.