

14.2: Liability under Securities Law

Learning Objectives

By the end of this section, you will be able to:

- Understand how the Foreign Corrupt Practices Act prevents American companies from using bribes to enter into contracts or gain licenses from foreign governments.
- Understand the liability for insider trading for corporate insiders, “tippees,” and secondary actors under Sections 16(b) and 10(b) of the 1934 Securities Exchange Act.
- Recognize how the Sarbanes-Oxley Act has amended the 1934 act to increase corporate regulation, transparency, and penalties.

Corporations may be found liable if they engage in certain unlawful practices, several of which we explore in this section.

The Foreign Corrupt Practices Act

Investigations by the Securities and Exchange Commission (SEC) and the Watergate Special Prosecutor in the early 1970s turned up evidence that hundreds of companies had misused corporate funds, mainly by bribing foreign officials to induce them to enter into contracts with or grant licenses to US companies. Because revealing the bribes would normally be self-defeating and, in any event, could be expected to stir up immense criticism, companies paying bribes routinely hid the payments in various accounts. As a result, one of many statutes enacted in the aftermath of Watergate, the Foreign Corrupt Practices Act (FCPA) of 1977, was incorporated into the 1934 Securities Exchange Act. The SEC’s legal interest in the matter is not premised on the morality of bribery but rather on the falsity of the financial statements that are being filed.

Congress’s response to abuses of financial reporting, the FCPA, was much broader than necessary to treat the violations that were uncovered. The FCPA prohibits an issuer (i.e., any US business enterprise), a stockholder acting on behalf of an issuer, and “any officer, director, employee, or agent” of an issuer from using either the mails or interstate commerce corruptly to offer, pay, or promise to pay anything of value to foreign officials, foreign political parties, or candidates if the purpose is to gain business by inducing the foreign official to influence an act of the government to render a decision favorable to the US corporation.

But not all payments are illegal. Under 1988 amendments to the FCPA, payments may be made to expedite routine governmental actions, such as obtaining a visa. And payments are allowed if they are lawful under the written law of a foreign country. More important than the foreign-bribe provisions, the act includes accounting provisions, which broaden considerably the authority of the SEC. These provisions are discussed in *SEC v. World-Wide Coin Investments, Ltd.*, 567 F.Supp. 724 (N.D. Ga. 1983), the first accounting provisions case brought to trial.

Insider Trading

Corporate insiders—directors, officers, or important shareholders—can have a substantial trading advantage if they are privy to important confidential information. Learning bad news (such as financial loss or cancellation of key contracts) in advance of all other stockholders will permit the privileged few to sell shares before the price falls. Conversely, discovering good news (a major oil find or unexpected profits) in advance gives the insider a decided incentive to purchase shares before the price rises.

Because of the unfairness to those who are ignorant of inside information, federal law prohibits insider trading. Two provisions of the 1934 Securities Exchange Act are paramount: Section 16(b) and 10(b).

Recapture of Short-Swing Profits: Section 16(b)

The Securities Exchange Act assumes that any director, officer, or shareholder owning 10 percent or more of the stock in a corporation is using inside information if he or any family member makes a profit from trading activities, either buying and selling or selling and buying, during a six-month period. Section 16(b) penalizes any such person by permitting the corporation or a shareholder suing on its behalf to recover the short-swing profits. The law applies to any company with more than \$10 million in assets and at least five hundred or more shareholders of any class of stock.

Suppose that on January 1, Bob (a company officer) purchases one hundred shares of stock in BCT Bookstore, Inc., for \$60 a share. On September 1, he sells them for \$100 a share. What is the result? Bob is in the clear, because his \$4,000 profit was not realized during a six-month period. Now suppose that the price falls, and one month later, on October 1, he repurchases one

hundred shares at \$30 a share and holds them for two years. What is the result? He will be forced to pay back \$7,000 in profits even if he had no inside information. Why? In August, Bob held one hundred shares of stock, and he did again on October 1—within a six-month period. His net gain on these transactions was \$7,000 (\$10,000 realized on the sale less the \$3,000 cost of the purchase).

As a consequence of Section 16(b) and certain other provisions, trading in securities by directors, officers, and large stockholders presents numerous complexities. For instance, the law requires people in this position to make periodic reports to the SEC about their trades. As a practical matter, directors, officers, and large shareholders should not trade in their own company stock in the short run without legal advice.

Insider Trading: Section 10(b) and Rule 10b-5

Section 10(b) of the Securities Exchange Act of 1934 prohibits any person from using the mails or facilities of interstate commerce “to use or employ, in connection with the purchase or sale of any security...any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.” In 1942, the SEC learned of a company president who misrepresented the company’s financial condition in order to buy shares at a low price from current stockholders. So the commission adopted a rule under the authority of Section 10(b). Rule 10b-5, as it was dubbed, has remained unchanged for more than forty years and has spawned thousands of lawsuits and SEC proceedings. It reads as follows:

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,

- (1) to employ any device, scheme, or artifice to defraud,
- (2) 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 the light of circumstances under which they were made, not misleading, or
- (3) 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.

Rule 10b-5 applies to any person who purchases or sells any security. It is not limited to securities registered under the 1934 Securities Exchange Act. It is not limited to publicly held companies. It applies to any security issued by any company, including the smallest closely held company. In substance, it is an antifraud rule, enforcement of which seems, on its face, to be limited to action by the SEC. But over the years, the courts have permitted people injured by those who violate the statute to file private damage suits. This sweeping rule has at times been referred to as the “federal law of corporations” or the “catch everybody” rule.

Insider trading ran headlong into Rule 10b-5 beginning in 1964 in a series of cases involving Texas Gulf Sulphur Company (TGS). On November 12, 1963, the company discovered a rich deposit of copper and zinc while drilling for oil near Timmins, Ontario. Keeping the discovery quiet, it proceeded to acquire mineral rights in adjacent lands. By April 1964, word began to circulate about TGS’s find.

Newspapers printed rumors, and the Toronto Stock Exchange experienced a wild speculative spree. On April 12, an executive vice president of TGS issued a press release downplaying the discovery, asserting that the rumors greatly exaggerated the find and stating that more drilling would be necessary before coming to any conclusions. Four days later, on April 16, TGS publicly announced that it had uncovered a strike of 25 million tons of ore. In the months following this announcement, TGS stock doubled in value.

The SEC charged several TGS officers and directors with having purchased or told their friends, so-called tippees, to purchase TGS stock from November 12, 1963, through April 16, 1964, on the basis of material inside information. The SEC also alleged that the April 12, 1964, press release was deceptive. The US Court of Appeals, in *SEC v. Texas Gulf Sulphur Co.*, *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968). decided that the defendants who purchased the stock before the public announcement had violated Rule 10b-5. According to the court, “anyone in possession of material inside information must either disclose it to the investing public, or, if he is disabled from disclosing to protect a corporate confidence, or he chooses not to do so, must abstain from trading in or recommending the securities concerned while such inside information remains undisclosed.” On remand, the district court ordered certain defendants to pay \$148,000 into an escrow account to be used to compensate parties injured by the insider trading.

The court of appeals also concluded that the press release violated Rule 10b-5 if “misleading to the reasonable investor.” On remand, the district court held that TGS failed to exercise “due diligence” in issuing the release. Sixty-nine private damage actions

were subsequently filed against TGS by shareholders who claimed they sold their stock in reliance on the release. The company settled most of these suits in late 1971 for \$2.7 million.

Following the TGS episode, the Supreme Court refined Rule 10b-5 on several fronts. First, in *Ernst & Ernst v. Hochfelder*, *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976), the Court decided that proof of scienter—defined as “mental state embracing intent to deceive, manipulate, or defraud”—is required in private damage actions under Rule 10b-5. In other words, negligence alone will not result in Rule 10b-5 liability. The Court also held that scienter, which is an intentional act, must be established in SEC injunctive actions. *Aaron v. SEC*, 446 U.S. 680 (1980).

The Supreme Court has placed limitations on the liability of tippees under Rule 10b-5. In 1980, the Court reversed the conviction of an employee of a company that printed tender offer and merger prospectuses. Using information obtained at work, the employee had purchased stock in target companies and later sold it for a profit when takeover attempts were publicly announced. In *Chiarella v. United States*, the Court held that the employee was not an insider or a fiduciary and that “a duty to disclose under Section 10(b) does not arise from the mere possession of nonpublic market information.” *Chiarella v. United States*, 445 U.S. 222 (1980). Following *Chiarella*, the Court ruled in *Dirks v. Securities and Exchange Commission* (see Section 24.3.2 “Tippee Liability”), that tippees are liable if they had reason to believe that the tipper breached a fiduciary duty in disclosing confidential information and the tipper received a personal benefit from the disclosure.

The Supreme Court has also refined Rule 10b-5 as it relates to the duty of a company to disclose material information, as discussed in *Basic, Inc. v. Levinson* (see Section 24.3.3 “Duty to Disclose Material Information”). This case is also important in its discussion of the degree of reliance investors must prove to support a Rule 10b-5 action.

In 2000, the SEC enacted Rule 10b5-1, which defines trading “on the basis of” inside information as any time a person trades while aware of material nonpublic information. Therefore, a defendant is not saved by arguing that the trade was made independent of knowledge of the nonpublic information. However, the rule also creates an affirmative defense for trades that were planned prior to the person’s receiving inside information.

In addition to its decisions relating to intent (*Ernst & Ernst*), tippees (*Dirks*), materiality (*Basic*), and awareness of nonpublic information (10b5-1), the Supreme Court has considered the misappropriation theory, under which a person who misappropriates information from an employer faces insider trading liability. In a leading misappropriation theory case, the Second Circuit Court of Appeals reinstated an indictment against employees who traded on the basis of inside information obtained through their work at investment banking firms. The court concluded that the employees’ violation of their fiduciary duty to the firms violated securities law. *United States v. Newman*, 664 F.2d 12 (2d Cir. 1981). The US Supreme Court upheld the misappropriation theory in *United States v. O’Hagan*, *United States v. O’Hagan*, 521 U.S. 642 (1997), and the SEC adopted the theory as new Rule 10b5-2. Under this new rule, the duty of trust or confidence exists when (1) a person agrees to maintain information in confidence; (2) the recipient knows or should have known through history, pattern, or practice of sharing confidences that the person communicating the information expects confidentiality; and (3) a person received material nonpublic information from his or her spouse, parent, child, or sibling.

In 1987, in *Carpenter v. United States*, *Carpenter v. United States*, 484 U.S. 19 (1987), the Supreme Court affirmed the conviction of a *Wall Street Journal* reporter who leaked advanced information about the contents of his “Heard on the Street” column. The reporter, who was sentenced to eighteen months in prison, had been convicted on both mail and wire fraud and securities law charges for misappropriating information. The Court upheld the mail and wire fraud conviction by an 8–0 vote and the securities law conviction by a 4–4 vote. (In effect, the tie vote affirmed the conviction.) *Carpenter v. United States*, 484 U.S. 19 (1987).

Beyond these judge-made theories of liability, Congress had been concerned about insider trading, and in 1984 and 1988, it substantially increased the penalties. A person convicted of insider trading now faces a maximum criminal fine of \$1 million and a possible ten-year prison term. A civil penalty of up to three times the profit made (or loss avoided) by insider trading can also be imposed. This penalty is in addition to liability for profits made through insider trading. For example, financier Ivan Boesky, who was sentenced in 1987 to a three-year prison term for insider trading, was required to disgorge \$50 million of profits and was liable for another \$50 million as a civil penalty. In 2003, Martha Stewart was indicted on charges of insider trading but was convicted for obstruction of justice, serving only five months. More recently, in 2009, billionaire founder of the Galleon Group, Raj Rajaratnam, was arrested for insider trading; he was convicted in May 2011 of all 14 counts of insider trading. For the SEC release on the Martha Stewart case, see <http://www.sec.gov/news/press/2003-69.htm>.

Companies that knowingly and recklessly fail to prevent insider trading by their employees are subject to a civil penalty of up to three times the profit gained or loss avoided by insider trading or \$1 million, whichever is greater. Corporations are also subject to a

criminal fine of up to \$2.5 million.

Secondary Actor

In *Stoneridge Investment Partners v. Scientific-Atlanta*, *Stoneridge Investment Partners v. Scientific-Atlanta*, 552 U.S. 148 (2008), the US Supreme Court held that “aiders and abettors” of fraud cannot be held secondarily liable under 10(b) for a private cause of action. This means that secondary actors, such as lawyers and accountants, cannot be held liable unless their conduct satisfies all the elements for 10(b) liability.

For an overview of insider trading, go to <http://www.sec.gov/answers/insider.htm>.

Sarbanes-Oxley Act

Congress enacted the Sarbanes-Oxley Act in 2002 in response to major corporate and accounting scandals, most notably those involving Enron, Tyco International, Adelphia, and WorldCom. The act created the Public Company Accounting Oversight Board, which oversees, inspects, and regulates accounting firms in their capacity as auditors of public companies. As a result of the act, the SEC may include civil penalties to a disgorgement fund for the benefit of victims of the violations of the Securities Act of 1933 and the Securities Exchange Act of 1934.

Key Takeaway

Corrupt practices, misuse of corporate funds, and insider trading unfairly benefit the minority and cost the public billions. Numerous federal laws have been enacted to create liability for these bad actors in order to prevent fraudulent trading activities. Both civil and criminal penalties are available to punish those actors who bribe officials or use inside information unlawfully.

Exercises

1. Why is the SEC so concerned with bribery? What does the SEC really aim to prevent through the FCPA?
2. What are short-swing profits?
3. To whom does Section 16(b) apply?
4. Explain how Rule 10b-5 has been amended “on the basis of” insider information.
5. Can a secondary actor (attorney, accountant) be liable for insider trading? What factors must be present?

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