Corporate Insider Trading in Saudi Arabia - A Comparative Analysis with the United States

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Nasser Saleh Altwayan

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Abstract

This dissertation examines the present regulations of corporate insider trading in the United States and Saudi Arabia and whether the two laws are doctrinally and practically similar or different. It also focuses on the strengths and weaknesses of the Saudi Arabian corporate insider trading regulations by comparing them with the U.S. regulations. This dissertation includes both descriptive and comparative analysis of the two countries' regulations. First, it describes and explains the regulations in the United States and Saudi Arabia. This dissertation then compares them focusing on the similarities and differences arising from the legal outcome of applying each country's regulations to a hypothetical case. The findings show that both countries' regulations share relatively similar regulations. However, there is some divergence between the two countries' regulations regarding the justification of the law and the reach of the regulations. The findings of this dissertation imply that the Saudi Arabian regulations are somewhat uncertain and ambiguous compared to the U.S. regulations. Therefore, this dissertation proposes recommendations to reform Saudi Arabian corporate insider trading regulations that benefit from the U.S. regulations, so they are more certain for all parties.

Table of Contents

List of Tables

Table of Abbreviations

ACRSD	Appeal Committee for Resolution of Securities Disputes
APR	Authorised Persons Regulations
CGR	Corporate Governance Regulations of 2017
CL of 1965	Companies Law of 1965
CL of 2015	Companies Law of 2015
CMA	Capital Market Authority
CML	Capital Market Law of 2003
CRSD	Committee for Resolution of Securities Disputes
LR of 2004	Listing Rules of 2004
LR of 2017	Listing Rules of 2017
MCR	Market Conduct Regulations of 2004
ROSCO	Rules on the Offer of Securities and Continuing Obligations
SEA	Securities Exchange Act of 1934
SEC	Securities and Exchange Commission

Chapter 1. Introduction

Little academic attention has been given to the subject of corporate insider trading in Saudi Arabia. Thus, I chose to study the regulations that govern this subject through a comparative analysis study with U.S. corporate insider trading law. This dissertation is an attempt to link corporate insider trading regulations in Saudi Arabia to the U.S. counterpart by examining the comprehensive federal securities laws, which have regulated corporate insiders trading since the 1930s.[1]

The main motivation for this dissertation is that corporate insider trading regulations have a direct impact on corporate insiders including their securities ownership and trading transactions. Since these regulations have not been analyzed in comprehensive studies in Saudi Arabia, there is a need to determine when corporate insiders can legally trade and when they cannot. Conducting this analysis increases awareness of corporate insider trading regulations among corporate insiders and public investors. In addition, studying the Saudi Arabian corporate insider trading regulations in a comparative analysis with the U.S. regulations enriches academic and legal studies in the area of securities laws. It will also raise awareness for the related public authorities of the differences and the similarities between the two countries' regulations.

This dissertation is structured into five chapters. Chapter 1 provides a general understanding of corporate insider trading and the regulatory framework in the United States and Saudi Arabia. Chapter 2 and 3 discuss the regulations of corporate insider trading by examining three main questions: (1) What is the legal status of corporate

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[1] *See* Thomas C. Newkirk & Melissa A. Robertson, *Speech by SEC Staff: Insider Trading - A U.S. Perspective*, (Sep. 19, 1998), https://www.sec.gov/news/speech/speecharchive/1998/spch221.htm.

insiders? (2) What are the regulations that govern their securities ownership and trading activities? and (3) What are the regulations that prohibit corporate insiders from trading on inside information? Chapter 4 provides a comparative analysis between the two countries' regulations by applying the regulations to a hypothetical case and assessing the differences and similarities between the regulations and a discussion of the resulting comparison. Chapter 5 concludes this dissertation including a summary of the findings and recommendations for reform for the Saudi Arabian corporate insider trading regulations.

What is Corporate Insider Trading?

This dissertation uses the term "corporate insiders" to refer to corporate directors, senior officers, and large shareholders. For the purpose of this dissertation, the term "corporate insider trading" means the purchase or sale of a stock of a listed corporation in a national exchange by one who has actual or constructive control of the corporation or who has legitimate access to inside information. The term "inside information" refers to information that is not publicly known and is only available to corporate insiders and others who are bound by a confidentiality and where the disclosure of such information would materially affect the market price of the traded stock.[2]

Although corporate insider trading is usually associated with the notion that it is illegal, it could also be legal. The basic rule is that corporate insiders are legally allowed to trade securities of their corporations based on their personal assessment, skill, and sophistication.[3] In fact, corporate insiders typically own a considerable amount of their

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[2] *See* THOMAS LEE HAZEN, TREATIES ON THE LAW OF SECURITIES REGULATIONS, 3 Law Sec. Reg., §12:160, Westlaw (database updated Nov. 2018); Roberta S. Karmel, *Outsider Trading on Confidential Information – A breach in Search of a Duty*, 20 Cardozo L. Rev. 83, 86 (1998).
[3] *See* HAZEN, *supra* note 2.

corporation's stock, and there are thousands of legal corporate insider trading reports every day.[4] However, although they are allowed to trade, they must comply with mandatory disclosure requirements and refrain from certain trading activities. Illegal corporate insider trading is mostly termed in judicial decisions and legal literature as "insider trading."[5] Insider trading is defined as: "trading by anyone (inside or outside the issuer) on any type of material nonpublic information about the issuer or about the market for the security."[6] It is also defined as "unlawful trading by persons possessing material nonpublic information, whether or not the trader is truly a corporate 'insider'."[7] The problem with the term insider trading is that it is a misnomer that has been more frequently used to cover the trading by any person who possesses an informational advantage over public investors based on the knowledge of information that has not been disclosed to the public, and its disclosure would significantly affect the price of the traded security.[8] However, trading while in possession of material non-public information can also be legal and lawful in several instances.[9] This dissertation uses the term "corporate insider trading" to mainly examine the rules governing the legal and illegal trading activities of corporate insiders. The use of this term is because corporate insiders are subject to additional rules and restrictions that go beyond the prohibition of trading on inside information including public reporting requirements that corporate outsiders would lack. In addition, corporate insiders

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[4] Richard H. Wagner; Catherine G. Wagner, *Recent Developments in Executive, Directors, and Employees Stock Compensation Plans: New Concerns for Corporate Directors*, 3 Stan. J.L. Bus. & Fin.5,8 (1997)
[5] *See* WILLAM K.S. & MARC I. STEINBERG, INSIDER TRADING, 1, (3rd ed. 2010).
[6] *Id*. *See* also DONALD C. LANGEVOORT, 18 INSIDER TRADING REGULATION, ENFORCEMENT AND PREVENTION, §1:1, Westlaw (database updated April 2018).
[7] JAMES D. COX ET AL, *SECURITIES REGULATIONS CASES AND MATERIALS,* 905 (7th ed. 2013).
[8] WANG & STEINBERG, *supra* note 5, at 1, Nt. 5; LANGEVOORT, *supra* note 6.
[9] LANGEVOORT, *supra* note 6. (Professor Donald Langevoort states that: "there is a circularity to the definition, insofar as the term is generally used to refer only to *unlawful* trading. There are numerous instances where persons who possess material nonpublic information can trade lawfully.") *Id*.

are the main target of securities regulations regarding trading on material non-public information. One of the problems, however, is that the reach of the prohibition of illegal corporate insider trading to corporate outsiders can differ between one law and another. Thus, the main goal of this dissertation is to examine the U.S. and Saudi Arabian regulations to compare when corporate insiders are legally allowed to trade and when their trading is illegal. One of the key purposes is to determine how the regulations are similar or different.

What are the Concerns about Corporate Insider Trading?

There are several concerns and reasons for securities regulators to govern and regulate corporate insider trading.

a. Fairness

The main concern of market securities regulators about corporate insider trading is that insiders could have an unerodable informational advantage over public investors because of insiders' privy position inside the listed corporation.[10] The concern is that corporate insiders are the first ones to know about material non-public information regarding the listed corporation or its traded security. The information will subsequently be released and disclosed to the public and will significantly affect the current market price of the security.[11] If corporate insiders are freely allowed to trade before the information is publicly disclosed, other investors would find themselves at a disadvantage position against corporate insiders that cannot be overcome.[12] As a result, public investors would lose

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[10] Victor Brudney, *Insiders, Outsiders, and Informational Advantages Under the Federal Securities Laws*, 93 HARV. L. REV. 322, 356 (1979).
[11] A.C. Hetherington, *Insider Trading and the Logic of the Law*, Wis. L. Rev. 720 (1967).
[12] *See* Kim Lane Scheppele, *"It's Just Not Right": The Ethics of Insider Trading*, 56 Law& Contemp. Probs, 123, 159 (1993).

confidence in the integrity of the securities markets and refrain from trading because they would believe that "the odds are stacked against them."[13] This notion is based on a concern about fairness in that securities markets should be a fair playing field where all investors should trade on equal access to information.[14] Persons "in the know" or who are well-connected must be prevented from taking advantage of other people who are outside and less-connected.[15] Professor Kim Lane Scheppele illustrated this notion of fairness by stating that fairness requires that investors should have an approximately calculable chance to win and investors should play on a level playing field.[16] Professor Scheppele explained this notion by finding that each investor typically takes a risk by investing in the market. However, when the risk is a deep secret of sort that is unknown or even unsuspected at the time of the investment, this type of risk is intolerable. Therefore, investors prefer a full disclosure policy to protect themselves from the risk of deep secrets that could not be suspected at the time of the trade.[17] To sustain a policy of a fair game investment field in which investors have a chance to win, they need to have equal access to information.[18] This means that they should have an equal cost of researching and acquiring information, not that they have the same information.[19] If corporate insiders can use secret information in their trades, the cost to acquire the information will be much lower for insiders than for public investors. Therefore, "the disparity in search cost makes the playing field no longer level."[20] Professor Sheppele also stated that, "When insiders trade with people who are in

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[13] WANG & STEINBERG, *supra* note 5, at 24; *Id*. at 157; *LANGEVOORT*, *supra* note 6, at §1:6.
[14] *Hetherington*, *supra* note 11, at 720; COX ET AL, *supra* note 7.
[15] *Id*.
[16] *Scheppele*, *supra* note 12, at 157.
[17] *Id*. at 158.
[18] *Id*. at 160.
[19] *Id*.
[20] *Id*. at 161.

no position, or a distinctly disadvantageous position, to acquire the information that the insiders now want to use, the insiders should have an obligation to disclose the information or refrain from trading with these unequal trading partners."[21]

b. Interruption of the Duty of Issuers' Public Disclosure

Securities regulators may be concerned that allowing corporate insider trading without restrictions would grant corporate insiders the opportunity to delay public disclosure about material information until they trade either to gain profits or avoid loss that would have occurred had they disclosed the information before they traded.[22] Therefore, the ban of misusing material non-public information encourages insiders to make timely public disclosures.[23] Some commentators suggest that there is a connection between the duty to make a timely disclosure and illegal corporate insider trading.[24] When securities regulations do not require timely disclosure of material information at the time it occurs, corporate insiders are more likely to use inside information in their trades. However, when securities regulations require a duty to make timely disclosure, the possibility of illegal corporate insider trading is reduced and decreased.[25]

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[21] *Id*. at 163.
[22] *See* Barbara J. Watson, *Prohibiting Insider Trading: Is it All Worth It*, 3 Eur. J. Crime Crim. L. & Crim. Just, 122,127 (1995); Stephen Bainbridge, *The Insider Trading Prohibition: A Legal and Economic Enigma*, 38 U. Fla. L. Rev. 35, 54 (1986).
[23] *Id*; *Karmel*, *supra* note 2, at 110-11; WANG & STEINBERG, *supra* note 5, at 27; HAROLD S. BLOOMENTHAL & SAMUEL WOLFF, *SECURITIES AND FEDERAL CORPORATE LAW*, 3C Sec. & Fed. Corp. Law, §19:1, (2d ed.) Westlaw (database updated Dec 2018). James J. Park, *Insider Trading and the Integrity of Mandatory Disclosure*, 2018 Wisconsin Law Review 1133, 104 (2018), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3258608.
[24] *Bloomenthal & Wolff*, *supra* note 23, at §19:1.
[25] *Id*.

c. Harm to Investors

Securities regulators are concerned about corporate insider trading because of the potential harm investors if insiders were allowed to freely trade based on non-public information without public disclosure.[26] The harm that can occur because of corporate insider trading would affect public investors as a group, as well as specific investors.[27] If corporate insiders are allowed to trade without a prohibition of trading on material non-public information, it would harm investors' confidence in the integrity of securities transactions.[28] As a result of such harm, some investors may decide to leave the market or refrain from participation, and other investors may require higher prices for sale transactions and lower prices for purchase transactions to offset the risk of being the victim of illegal corporate insider trading.[29] This result would raise the cost of capital. Professor Victor Brudeny stated that:

> If the market is thought to be systematically populated with such transactors some investors will refrain from dealing altogether, and others will incur costs to avoid dealing with such transactors or corruptly to overcome their unerodable informational advantages. None of those responses is socially useful. All raise the cost of capital.[30]

Professors William Wang and Marc Steinberg claimed that every act of illegal corporate insider trading has certain victims.[31] These victims are "who would be better off,

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[26] *See* WANG & STEINBERG, *supra* note 5, at 24; *Id*. at 24; Bainbridge, *supra* note 22, at 49; Jie Hu & Thomas H. Noe, *The Insider Trading Debate*, Federal Reserve Bank of Atlanta, Economic Review, 4th Quarter (1997), https://www.frbatlanta.org/-/media/documents/research/publications/economic-review/1997/vol82no4_hu-noe.pdf.

[27] *Id*.

[28] *Bainbridge*, *supra* note 22, at 59; WANG & STEINBERG, *supra* note 5, at 24.

[29] WANG & STEINBERG, *supra* note 5, at 24; George W. Jr. Dent, *Why Legalized Insider Trading Would be a Disaster*, 38 Del. J. Corp. L. 247, 260 (2013); Joel Seligman, T*he Reformulation of Federal Securities Law Concerning Nonpublic Information*, 73 Geo. L. J. 1083, 118 (1986).

[30] *Brudney*, *supra* note 10, at 356. *See* WANG & STEINBERG, *supra* note 5, at 31.

[31] WANG & STEINBERG, *supra* note 5, at 55.

but for the act of insider trading." However, identifying these victims can be extremely difficult or even impossible.[32] Professor Wang illustrated that:

> This injury is demonstrated by examining stock holdings at the time of public dissemination of the information. With an insider *purchase* of an existing issue of securities, the buyer has more of that issue at dissemination; someone else must have less. That 'trade victim' is worse off because of the insider trade. With an insider *sale* of an existing issue of securities, the seller has less of that issue at dissemination; someone else must have more. That 'trade victim' is worse off because of the insider trade.[33]

d. Market Liquidity

Securities regulators have an interest in restricting corporate insider trading and prohibiting insiders from trading on material non-public information to protect the market liquidity.[34] Some economic studies have shown that allowing corporate insiders to trade on the basis of inside information decreases market liquidity and raises the cost of capital.[35] Professor Franklin Gevurtz notices that: "Governments have come to believe that among the regulations necessary…for deep and liquid stock markets is a ban on at least some amount of trading on inside information."[36]

When corporate insiders are allowed to trade on inside information before public disclosure, market makers, as frequent traders, may increase the bid-ask spreads to avoid

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[32] *Id. at* 73.
[33] *Id*. at 55-56.
[34] WANG & STEINBERG, *supra* note 5, at 24; *Id*. at 68. Laura E. Hughes, *The Impact of Insider Trading Regulations on Stock Market Efficiency: A Critique of the Law and Economics Debate and a Cross-Country Comparison*, 23 Temp, Int'l & Comp. L.J. 479, 493-94(2009). (The author defines market liquidity as "the ratio of the market turnover to market capitalization and is relatively straightforward to measure. Liquidity refers to the direct and indirect transaction costs of trading. In a liquid stock market, stocks are bought and sold freely and easily, and buyer and seller of a stock are able to immediately find one another.") *Id*.
[35] Laura Nyantung Beny, *Insider Trading Laws and Stock Markets Around the World: An Empirical Contribution to the Theoretical Law and Economic Debate*, 32 J. Corp. L. 237, 277 (2007); *Dent*, *supra* note 29, at 259.
[36] Franklin A. Gevurtz, *The Globalization of Insider Trading prohibitions*, 15 Transnat'I Law. 63, 68 (2002), *available at*: https://scholarlycommons.pacific.edu/cgi/viewcontent.cgi?article=1012&context=facultyarticles.

being victims of illegal corporate insider trading.[37] The increased of bid-ask spreads may harm other frequent traders such as speculators.[38] As a result, frequent traders may refrain from trading causing the market to be illiquid.[39]

Academic Debate on Deregulation of Corporate Insider Trading

Deregulation of corporate insider trading is an unresolved and continuing debate among economic and legal scholars of whether corporate insider trading should be deregulated.[40] The most famous opponent of regulating corporate insider trading was Professor Henry Manne, who was the first to raise the argument.[41] Commentators supporting deregulations assert that the question is whether firms' owners would allow their firms' agents to trade on inside information. Then, it would be up to the shareholders to decide whether such a trade is efficient, and therefore, allow it or not.[42] Deregulators argued that there is no substantial harm in allowing illegal corporate insider trading. In fact, allowing it would benefit the corporation and the market.[43] Professor Henry Manne argued that public investors are not harmed from illegal corporate insider trading.[44] He concluded that the only traders who would be harmed from corporate insiders' trade on inside information are speculators who are motivated to trade based on the price movement and

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[37] WANG & STEINBERG, *supra* note 5, at 67.
[38] *Id*. at 68.
[39] *Beny*, *supra* note 35, at 250; *Hughes*, *supra* note 34, at 495.
[40] *See* WANG & STEINBERG, *supra* note 5, at 9; *Dent*, *supra* note 29, at 249; *Bainbridge*, *supra* note 22, at 42; Alan Strudler & Eric W. Orts, *Moral Principle in the Law of Insider Trading*, 78 Tex. L. Rev. 375, 382-83 (1999).
[41] HENRY G. MANNE, INSIDER TRADING AND THE STOCK MARKET (1966). *See* Richard W. Painter, *Insider Trading and the Stock Market Thirty Years Later*, 50 Case W. Res. L. Rev. 305 (2000).
[42] *Bainbridge*, *supra* note 22, 42.
[43] *Id*; *Dent*, *supra* note 29, at 249.
[44] MANNE, *supra* note 41, at 99,102; Henry G. Manne, *Insider Trading: Hayek, Virtual Markets, and the Dog that Did not Bark,* Journal of Corporation Law, Vol, 31, N0. 1, 2 (2005), *available at*: http://ssrn.com/abstract_id=679662; *Watson*, *supra* note 22, at 124-25.

who are looking to gain short-swing profits. However, these speculators are not true investors.[45] Professor Manne also found that the concern about a substantial effect on market makers because of deregulating corporate insider trading "is theoretically feasible," but "it seems to be practically irrelevant in the real world."[46]

Some commentators have also argued that, based on economic efficiency, the fairness concern that is based on the need for equal access to information is unrealistic.[47] This is because information is imperfect and informational asymmetry is inevitable in the market.[48] Professor Donald Langevoort said that: "large numbers of people are actually led to trade by the belief (often a false hope, but nonetheless carefully fostered by some brokers, investment advisers, and the like) that they themselves have some sort of inside advantage."[49] In addition, imposing a rule of equal access to information may discourage the research and the production of information that securities professionals provide which is an important method to improve the information efficiency of the market.[50] Professor Frank Easterbrook also argued that corporate insiders' informational advantage is not related to whether outsiders have access to information or not, but rather is about the cost of acquiring the information. The disparity of the cost of acquiring information is "simply a function of the division of labor…but unless there is something unethical about the division of labor, the difference is not unfair."[51]

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[45] *Manne*, *supra* note 41, at 108; *Manne*, *id*. at 3.
[46] *Manne*, *supra* note 44, at 1-3.
[47] FRANKLIN A. GEVURTZ, CORPORATION LAW, 631 (2nd ed. 2010).
[48] *Strudler & Orts*, *supra* note 40, at 400-01; *Bainbridge*, *supra* note 22, at 57-58.
[49] Donald C. Langevoort, *Rereading Cady, Roberts: The Ideology and practice of insider trading regulation,* 99 Colum. L. Rev. 1319, 1326 (1999).
[50] *Strudler & Orts*, *supra* note 40, 400-01.
[51] Frank H. Easterbrook, *Insider Trading, Secret Agents, Evidentiary Privileges, and the Production of Information*, The Supreme Court Review, Vol. 1981, 309, 330 (1981) https://www-jstor-org.ezp3.lib.umn.edu/stable/3109548?seq=1#metadata_info_tab_contents; *Bainbridge*, *supra* note 22, at 58-59.

Deregulators have also argued that two main benefits of deregulating corporate insider trading. First, allowing insiders to trade on inside information is the best tool for compensating them for their entrepreneurship and innovation. Second, it is an efficient mechanism to accurately price securities in stock markets.

a. Efficient Tool to Compensate Corporate Insiders

Deregulators have argued that allowing corporate insider trading is the best method to compensate insiders as entrepreneurs and to encourage innovations.[52] Professor Manne realized that entrepreneurship is "a functional condition relating to innovational activity." This innovational "activity is not always easy to identify or distinguish in an advance."[53] Professor Stephen Bainbridge illustrated Manne's argument by stating that the contribution of entrepreneurs to the corporation constitutes the "production of new information that is valuable to the firm." For the purpose of giving entrepreneurs ways to invent new information, it is difficult to determine the compensation of such innovation. Therefore, a salary is not a suitable means to compensate entrepreneurs.[54] Professor Manne concluded that corporate insider trading "meets all the conditions for appropriately compensating entrepreneurs."[55] Furthermore, Professors Dennis Carlton and Daniel Fischel have argued that corporate managers and shareholders have a divergence of interest.[56] They found that fixed compensation does not solve the problem of agency-cost and suggested that periodic renegotiation of managers' compensation is an alternative solution to this problem.[57] Since

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[52] *See* WANG & STEINBERG, *supra* note 5, at 10; *Bainbridge*, *supra* note 19, at 46.
[53] *Manne*, *supra* note 41, at 116,17.
[54] Bainbridge, *supra* note 22, at 46.
[55] *Manne*, *supra* note 41, at 138.
[56] Dennis W. Carlton & Daniel R. Fischel, *The Regulation of Insider Trading*, 35 Stan. L. Rev. 857, 870 (1983).
[57] *Id*; *Bainbridge*, *supra* note 22, at 46.

contract-based renegotiation is costly because it requires monitoring the performance of managers and determining the output of each manager, they suggested that allowing corporate managers to trade on inside information could solve the problem of the cost of renegotiation.[58]

Some deregulators have also argued that allowing corporate insiders to trade on inside information has drawbacks but can bring some benefits.[59] They have reasoned that inside information belongs to the corporation as a property right so it is up to the corporation to decide whether to allow corporate insiders to use this information in their trades or not.[60] Professor Richard Painter stated that the cost and benefit of allowing corporate insiders to trade on inside information "are likely to be reflected in an issuer's cost of capital. If so, it is arguably appropriate for the issuer to decide whether restrictions on insider trading should apply, and if so, how broad those restrictions should be."[61]

Commentators advocating for regulating corporate insider trading, however, have rebutted these arguments by highlighting several flaws with this logic.[62] They have contended that it is uncertain whether allowing corporate insider trading is a useful mechanism to compensate insiders because it is difficult to ascertain who produces the information.[63] Therefore, lazy managers, who had no part in the production of the information, would share the profits from the information.[64] In addition, this claim ignores that the profit made from trading on inside information is not based on the value of an

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[58] *Id*.
[59] *See Beny*, *supra* note 35, at 246; *Painter*, *supra* note 41, at 306.
[60] *Id*; WANG & STEINBERG, *supra* note 5, at 33.
[61] *Painter*, *supra* note 41, at 306.
[62] *See* WANG & STEINBERG, *supra* note 5, at 10.
[63] *Id*; Bainbridge, *supra* note 22, at 46; *Dent*, *supra* note 29, at 267.
[64] *Id*.

insider's contribution in the production of the information, but rather is based on the wealth of the insider.[65] Another rebuttal is that allowing insiders to freely trade on inside information is detrimental to the issuer because insiders would be incentivized to enter into high-risk projects and make more profits by benefiting from the volatility of the securities price.[66]

b. Efficient Mechanism to Accurately Price Securities

Another argument of deregulators is that allowing corporate insiders to freely trade on a corporation's stock would improve the efficiency of the stock market by accurately pricing securities, which would, in turn, improve capital allocation and reduce volatility and uncertainty.[67] "Share price is relatively 'accurate' if it is likely to be relatively close, whether above or below, to the share's actual value. When a price has a high expected accuracy, the deviation of the price from actual value is, on average, relatively small."[68] In a securities market where issuers are not required to make full disclosure of new material developments or even in securities markets that require a continuous disclosure paradigm, in certain circumstances the public disclosure is adverse to the interest of the issuer and its shareholders and the issuer may have a legitimate purpose to delay the disclosure.[69] Therefore, allowing corporate insiders to trade on inside information would give the issuer another way to communicate with the public to correct the error of the stock price when the issuer prefers to delay the disclosure.[70] As a result, the issuer would maintain having

[65] Bainbridge, *supra* note 19, at 47-84.
[66] WANG & STEINBERG, *supra* note 5, at 12.
[67] *See Id*. at 14; *Bainbridge*, *supra* note 22, at 42; *Beny*, *supra* note 35, at 250
[68] Merritt B. Fox et. al., *Law, Share Price Accuracy, and Economic Performance: The New Evidence*, 102 Mich. L. Rev. 331, 345 (2003). *See Beny*, *supra* note 35, at 246.
[69] *Bainbridge*, *supra* note 22, at 42-43; *Carlton & Fischel*, *supra* note 56, at 879; *W* WANG & STEINBERG, *supra* note 5, at 20.
[70] *Id*.

the right to delay public disclosure and the mechanism to impute the information into the security price through corporate insider trading with the goal of maintaining accurate stock prices and enhancing market efficiency.[71] These deregulators also rebutted the concern that corporate insiders may intentionally delay public disclosure to benefit themselves by trading on the subsequently disclosed information.[72] Professors Carlton and Fischel have found that although this concern is possible, it has little empirical ground.[73] In fact, allowing corporate insiders to trade on inside information may strongly encourage insiders to accelerate public disclosure to gain profits from their trade.[74]

However, commentators supporting regulating corporate insider trading rebutted the argument of accurately pricing securities by stating that although corporate insider trading may improve the accuracy of the price of securities, the effect would be small and insignificant.[75] Therefore, it is not a useful tool to increase the efficiency of securities markets.[76]

Conclusion

It can be concluded that both sides have roughly close arguments in the legal and economic debate of whether corporate insider trading should be regulated or deregulated.[77] However, as many commentators have criticized both sides, most of the benefits or harms that are allegedly associated with the regulation or deregulation of corporate insider trading

[71] *Bainbridge*, *supra* note 22, at 42-43.
[72] *See Bainbridge*, *supra* note 22, at 50; *Carlton & Fischel*, *supra* note 56, at 879; *Watson*, *supra* note 22, at 127. *See* also *Karmel*, *supra* note 2, at 133.
[73] *Carlton & Fischel*, *supra* note 56, at 879.
[74] *Id*. *See Watson*, *supra* note 22, at 127.
[75] WANG & STEINBERG, *supra* note 5, at 21; *Dent*, *supra* note 29, at 250; *Bainbridge*, *supra* note 22, at 44-45.
[76] *Id*.
[77] *See* WANG & STEINBERG, *supra* note 5, at 39; *Bainbridge*, *supra* note 22, at 68; *LANGEVOORT*, *supra* note 6, at §1:6; *Strudler* & *Orts*, *supra* note 40, at 382-83.

are speculative and theoretical in nature.[78] Nevertheless, it can be concluded that the core underlying motivation to regulate corporate insider trading is based on the ethical concept that it is unfair and immoral to allow corporate insiders to abuse the trust reposed on them by the exploitation of inside information for personal gain.[79] This suggestion also acknowledges that there is an economic basis supporting regulating corporate insider trading.[80] In particular, for frequent traders, there is potential harm to frequent traders from deregulating corporate insider trading, including speculators who may reduce the market liquidity.[81] Nevertheless, it is doubtful that any economic basis alone without the ethical rule would be grounds to regulate or deregulate corporate insider trading.

Although the prevailing view is that it is necessary to regulate corporate insider trading,[82] the question is how to translate this ethical notion into legal rules and what is the scope of such rules? Should the rules be general or restricted? To answer this question, this dissertation examines the U.S. and Saudi Arabian corporate insider trading regulations including the similarities and differences between the two countries' regulations in the scope of the regulations and legal justifications.

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[78] *Id*. *See* also *WANG & STEINBERG, supra* note *5,* at 96.

[79] *See LANGEVOORT, supra* note *6, at* §1:6; *WANG & STEINBERG, supra* note 5, at 97; *Langevoort*, *supra* note 49, at 1227-28; *Strudler* & *Orts*, *supra* note 40, at 383.

[80] *See* Merritt B. Fox et al, Informed Trading and Its Regulation, J. Corp, L. 43, No. 4, 817, 839-40 (2018) *available at:* https://repository.law.umich.edu/articles/2009/; Donald C. Langevoort, *From Texas Gulf Sulphur to Chiarella: A Tale of Two Duties*, Georgetown University Law Center, 6-7 (2017), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3091189.

[81] *See supra* notes 34-39 and accompanying text. *See* also *Beny*, *supra* note 35, at 280-83.

[82] Donald C. Langevoort, *Cross-Border Insider Trading*, 19 Dick. J. Int'l L. 161, 166 (2000) *available at*: https://scholarship.law.georgetown.edu/facpub/140/.

Background

I. U.S. Regulatory Framework

Corporate insider trading in the United States is regulated by federal securities laws and administrative rules issued by the SEC. However, the issue is largely governed by federal case-law as discussed later in this dissertation. Before examining the U.S. regulation of corporate insider trading, it is helpful to briefly describe the federal regulatory framework in relation to corporate insider trading. Below is a description of the federal securities laws by which corporate insider trading is regulated, and the Securities Exchange Commission (SEC) as the regulatory agency that is authorized to issue administrative rules governing corporate insider trading.

a. Federal Securities Laws

Two statutes constitute the fundamental laws that govern federal securities: the Securities Act of 1933[83] and the Securities Exchange Act of 1934 (SEA).[84] The Securities Act mainly governs the initial public offering of securities in the primary market (IPO) and the distribution of securities.[85] The SEA governs a broader range than the Securities Act,[86] governing and regulating all aspects of the secondary securities trading markets,[87] including the issuers and their insiders, the exchange, the over-the-counter markets, broker/dealers, and purchasers and sellers.[88] It is noteworthy that there is no federal

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[83] The Securities Act of 1933, Act of May 27, 1933, c. 38, Title I, §1, 48 Stat. 74, 15 U.S.C.A. §§77a (2012). *See* HAZEN, *supra* note 2, at §1:3.
[84] The Securities Exchange Act of 1934, Act of June 6, 1934, C. 404, Title, I, §1, 48 Stat. 881, 15 U.S.C.A. §§78a (2012). DONNA M. NAGY ET AL, *SECURITIES LITIGATION AND ENFORCEMENT CASES AND MATERIALS*, 2 (3rd ed. 2012).
[85] *Id*; COX ET AL, *supra* note 7, at 5; HAZEN, *supra* note 2, at §1:17.
[86] HAZEN, *supra* note 2, at §1:18.
[87] *Id*; COX ET AL, *supra* note 7, at 8-9.
[88] *Id*.

common law of securities.[89] The source of securities laws are the statutes.[90] In addition federal securities laws can be found under administrative law in the form of administrative rules and cases issued or ruled by the SEC.[91] However, when a statutory provision is ambiguous or highly general, federal courts turn to common law as a "supplemental source of law."[92] This supplemental use of common law is clear in the area of corporate insider trading under the interpretation of Section 10(b) of the SEA.[93]

One of the principal goals that the SEA was enacted to accomplish was "to substitute a philosophy of full disclosure for the philosophy of caveat emptor and thus to achieve a high standard of business ethics in the securities industry."[94] The SEA is a disclosure-oriented regulation containing several mandatory continuous disclosure provisions.[95] The philosophy was that securities prices shall not be a reflection of abusive conduct including manipulation, but prices should mirror sophistication.[96] The SEA requires issuers to make mandatory periodic disclosure reports filed with the SEC.[97] Issuers are required to file annual reports that include financial statements, a description of the

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[89] HAZEN, *supra* note 2, at §1:3. Common law means: "the body of law derived from judicial decisions, rather than from statutes or constitutions." "where the common law governs, the judges…decided the case in accordance with morality and custom and later judges followed his decision. They did not do so by construing the words of his judgment. They looked for the reason which had made him decide the case they way he did…Tus it was the principle of the case not the words, which went into the common law." American common law is "[t]he body of judge-made law that developed during and after the United States' colonial period, esp. since independence." Black's Law Dictionary (10th ed. 2014).
[90] HAZEN, *supra* note 2, at §1:3.
[91] *Id*. at §1:4.
[92] *Id*. at §1:3.
[93] *15 U.S.C.A. §78j. Id. See* also ARNOLD S. JACOBS, 5B DISCLOSURE AND REMEDIES UNDER THE SECURITIES LAWS, § 1:1, *Westlaw*. (database updated Dec. 2018).
[94] *Affiliated Ute Citizens of Utah v. U.S.*, 406 U.S. 128, 151 (1972) Citing S*EC v. Capital Gains Research Bureau*, 375 U.S. 180, 186 (1963). *See* Dennis S. Karjala, Federalism, *Full Disclosure, and the National Markets in the Interpretation of Federal Securities Law*, 80 Nw. U. L. Rev. 1473, 74 (1986). Caveat emptor is a "doctrine holding that a purchaser buys at his or her own risk." Blacks' Law Dictionary (10th ed. 2014).
[95] *See* COX ET AL, *supra* note 7, at 9.
[96] *Id*. at 8.
[97] *See Id*. at 9; MARC I. STEINBERG, UNDERSTANDING SECURITIES LAW, §5 (7th ed. 2018) (ebook).

issuer's business and performance, and management discussion.[98] They are also required to provide quarterly reports in the issuer's fiscal year.[99] In addition, issuers are required to promptly disclose specific material events and changes when they occur.[100]

The SEA also contains a different scheme to ensure protection for investors and honesty in securities markets.[101] This scheme is reflected by enacting general anti-fraud and manipulation provisions.[102] Section 10(b) of the SEA and Rule 10b-5 thereunder are the most important antifraud provisions.[103] Section 10(b) and Rule 10b5- are "catch-all" provisions making it unlawful to use any deceptive or manipulative device in connection with the purchase or sale of a security.[104] Section 10(b) and Rule 10b-5 are used to prohibit misrepresentations, omissions of material facts as well as the prohibition of illegal corporate insider trading.[105]

b. <u>Securities and Exchange Commission (SEC)</u>

Section 4 of the SEA enacted the SEC as an independent "super agency."[106] The SEC has four main powers: rulemaking, adjudication, investigation, and enforcement powers.[107] Under the rulemaking power, the SEC has issued three types of rules: procedural rules, rules issued under statutory provisions that delegated the SEC as the authority to regulate, and rules that define statutory terms.[108] The SEC is considered as one of the most

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98 *Id*.
99 *See* COX ET AL, *supra* note 7, at 10.
100 *Id*; STEINBERG, *supra* note 97, at §11:07.
101 *See* HAZEN, *supra* note 2, at §1:18; STEINBERG, *supra* note 97, at §8.01; NAGY ET AL, *supra* note 84, at 6.
102 *Id*.
103 Rule 10b-5, *17 C.F.R. § 240*. STEINBERG, *supra* note 97, at §8.01; NAGY ET AL, *supra* note 81, at 6.
104 *Id*.
105 *Id*.
106 15 U.S.C.A. § 78d. (2012). THOMAS LEE HAZEN, PRINCIPLES OF SECURITIES REGULATION, REVISED, 22 (4th ed. 2017).
107 *Id*.
108 HAZEN, *supra* note 2, at §1:4.

professional and active federal agencies in the United States.[109] Considering their broad rulemaking power, the SEC must determine before issuing such rules, "whether an action is necessary or appropriate in the public interest, [] [the SEC] shall consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation."[110]

c. **Corporate Law**

State law governs the internal affairs of corporations, including the relationship between corporate insiders and the corporation or its shareholders.[111] Although some aspects of corporate legal matters are governed by federal securities laws, such as tender offers, proxy solicitations, and corporate insider trading, each U.S. state has its own corporate law, and every corporation is generally governed by the state where the corporation has been incorporated.[112] The United States Supreme Court clearly states that, "Corporations are creatures of state law, and investors commit their funds to corporate directors on the understanding that, except where federal law expressly requires certain responsibilities of directors with respect to stockholders, state law will govern the internal affairs of the corporation."[113] Delaware's corporate law is the most influential corporate law in the U.S.[114] The superiority of Delaware's corporate law is demonstrated by the fact that more than 60% of the Fortune 500 corporations in the U.S. are incorporated in

[109] HAZEN, *supra* note 106, at 22.
[110] 15 U.S.C.A. § 78c. (2012). *See* COX ET AL, *supra* note 7, at 17.
[111] ROBERT HAMILTON ET AL, THE LAW OF BUSINESS ORGANIZATIONS-CASES, MATERIALS, AND PROBLEMS, 151 (12th ed.); RONALD J. COLOMBO, LAW OF CORPORATE OFFICERS AND DIRECTORS: RIGHTS, DUTIES AND LIABILITIES, §1:4. Westlaw (database updated Oct. 2017).
[112] *Id.*
[113] *Santa Fe Industries, Inc. V. Green,* 430 U.S. 462, 479 (U.S. 1977) (quoting *Cort v. Ash*, 422 U.S. 66, 84 (1975).
[114] HAMILTON ET AL, *supra* note 111, at 156; COLOMBO, *supra* note 111, at §1:4.

Delaware.[115] Commentators suggest that the attractiveness of incorporating in Delaware may be due to the judicial expertise in corporate affairs and the widely-recognized precedents that have been produced over the years.[116] In addition, the Model Business Corporate Act (MBCA), which is promulgated by the American Bar Association (ABA), has considerable influence on other states' corporate laws.[117] As of 2016, 32 states in the U.S. in addition to the District of Columbia have adopted the MBCA.[118]

d. Regulatory Framework of Corporate Insider Trading Regulations

The sources of U.S. corporate insider trading regulations are statutory provisions, case-law, and administrative rules issued by the SEC. Section 16 of the SEA is the provision that expressly governs corporate insider trading activities.[119] First, Section 16(a) obligates corporate directors, officers, and holders of more than 10 percent of a class of an equity registered pursuant to Section 12 of the SEA,[120] to publicly report their beneficial ownership.[121] Corporate insiders are required to report once they become insiders and disclose a list of all equity securities they own and all transactions in the corporation's security that result in a change in beneficial ownership of the insiders.[122] Section 16(b) of the SEA prohibits corporate insiders from gaining short-swing profits, in which corporate insiders purchase and sell or sell and purchase securities within a period of less than six

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[115] *See* Delaware Corporate Law Website, https://corplaw.delaware.gov/why-businesses-choose-delaware/ (last visited July. 15, 2018) *id*.
[116] HAMILTON ET AL, *supra* note 111, at 156.
[117] RICHARD D. FREER & DOUGLAS K. MOLL, PRINCIPLES OF BUSINESS ORGANIZATIONS, 171 (2d ed. 2018).
[118] *2016 Revision to Model Business Corporation Act Makes Its Debut*, (visted July.18 2018) *available at* American Bar Association.
[119] Section 16 of the SEA, 15 U.S.C.A. §78p. (2012). Michael J. Kaufman, *Section 16(b) and its Limitations period: The Case for Equitable Tolling*, 39 SEC. REG. L. J.I 169 (2011).
[120] 15 U.S.C.A. § 78l. (2012).
[121] Section 16(a) of the SEA, 15 U.S.C.A. §78p. (2012).
[122] *Id*.

months and make a profit. If corporate insiders violate this Section, they must disgorge the full profit that they have gained from the violated transactions back to the reporting company.[123] Moreover, Section 16(c) of the SEA prohibits insiders from transacting short sales of their corporations' securities.[124] Nevertheless, Section 16(b) of the SEA did not prohibit corporate insiders from trading on inside information and insiders were not prohibited from trading on inside information.[125]

The source of the prohibition against corporate insider trading on inside information before public disclosure is a judge-made law that has been developed since 1961, SEC's administrative enforcement action in the *Matter of Cady, Roberts*,[126] based on the interpretation of the anti-fraud provisions of Section 10(b) of the SEA and Rule 10b-5 thereunder, in which such trade was construed to involve fraud and deception prohibited under these provisions.[127] Section10(b) of the Securities Exchange Act of 1934 states that:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce of the mails, or of any facility of any national securities exchange…(b) to use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered or any securities based swap agreement any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commissions may prescribe as necessary or appropriate in the public interest or for the protection of investors.[128]

Rule 10b-5 states 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, (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 the light of the circumstances under which they were made,

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[123] Section 16(b) of the SEA, *id*.
[124] Section 16(c) of the SEA. *id*.
[125] *See infra* notes 265-82 and accompanying text.
[126] Cady, Roberts & Co., Re, 40 S.E.C. 907 (1961).
[127] *See infra* notes 473-92 and accompanying text.
[128] 15 U.S.C.A. §78j. (2012).

> not misleading, or (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.[129]

Although the language of Section10(b) and Rule 10b-5 does not precisely state that trading without disclosure of material non-public information constitutes a manipulative or deceptive device, Section10(b) and Rule 10b-5 provisions were designed to be catch-all clauses to deter all fraudulent practices in connection with the purchase or sale of securities.[130] The SEC and federal courts interpreted Section 10(b) and Rule 10b-5 to mean that the failure to disclose material non-public information in connection with the purchase or sale of securities may operate as a fraud under Section 10(b) disregarding the absence of statutory language or legislative history precisely prohibiting the failure to comply with the duty to disclose.[131]

The scope of persons who are subject to the prohibition of trading on the basis of material non-public information goes beyond traditional corporate insiders to include certain outsiders. However, the U.S. Supreme Court narrowed the broad range of persons subject to the prohibition of illegal corporate insider trading. In three judicial decisions,[132] the Supreme Court restricted the reach of the prohibition of illegal corporate insider trading to persons trading on material non-public information who have a direct or derivative duty to disclose such acquired or discovered information that arises from a fiduciary-like relationship either to the other party in a security transaction or the source of the information.[133]

[129] 17 C.F.R. § 240.10b-5.
[130] *See infra* notes 423-31 and accompanying text.
[131] *Chiarella v. United States*, 445 U.S. 222, 226-23 (1980). *See id*.
[132] *Id*; *Dirks v. SEC*., 463 U.S. 646 (U.S. 1983); *U.S. v. O'Hagan,* 521 U.S. 642 (U.S.1997).
[133] For detailed discussion of who is subject to the prohibition, *see infra* Part 3 of Chapter 2 of this dissertation.

Congress enacted three laws to amend the SEA regarding corporate insider trading mainly to increase the sanctions of violations.[134] The first law was the Insider Trading Sanctions Act of 1984.[135] The goal of enacting this Act was to assure the public and protect the honesty and fairness of the securities markets by increasing the sanctions and providing an additional remedy to the SEC to enforce the prohibition.[136] This Act allowed the SEC to seek a civil penalty up to three times the amount of the profit gained or loses avoided from illegal corporate insider trading. This Act also increased criminal financial sanctions.[137] The second congressional enactment was the Insider Trading and Securities Fraud Enforcement Act of 1988 (ITSFEA).[138] ITSFEA amended SEA and granted the SEC the right to seek civil penalties to be paid by controlling persons, increased criminal sanctions, and granted an express private right of action for contemporaneous traders against persons violating the prohibition of illegal corporate insider trading.[139] The last statute was the Stop Trading on Congressional Knowledge Act of 2012 (STOCK).[140] This Act makes it clear that the prohibition of illegal corporate insider trading applies to members and employees of Congress, and other federal officials.[141]

The SEC has issued four administrative rules and regulations regarding illegal corporate insider trading prohibition. The first rule was Rule 14e-3,[142] promulgated under

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[134] *See infra* notes 1109-32. *See* also *LANGEVOORT, supra* note *6, at* §2:13.
[135] Insider Trading Sanctions Act of 1984 (ITSA), Pub. L. No 98–376, 98 Stat. 1264, (1984).
[136] *LANGEVOORT, supra* note *6, at* §2:13.
[137] *See infra* notes 1111-13.
[138] Insider Trading and Securities Fraud Enforcement Act of 1988 (ITSFEA), Pub, L. 100-704, 100 Stat. 4677 (1988).
[139] *See infra* notes 1114-20 and accompanying text.
[140] Stop Trading on Congressional Knowledge Act of 2012 (STOCK), Pub. L. No 112–105, 126 Stat. 291 (2012).
[141] *Id*. §3, 4, and 9. *See* Michael V. Seitzinger, *Federal Securities Law: Insider Trading*, Congressional Research Services, 7-5700, RS21127, (2016) available at: https://fas.org/sgp/crs/misc/RS21127.pdf.
[142] Rule 14e-3, 1*7 C.F.R. § 240.14e–3.*

Section 14(e) of the SEA,[143] which prohibits trading while in possession of material non-public information related to a tender offer.[144] In 2000, the SEA issued three additional rules and regulations: Rule 10b5-1 defines when trading on the basis of material non-public information occurs and provides an affirmative defenses that insiders can use to shield themselves from liability even if the trade was made while in possession of material non-public information.[145] The second rule was Rule 10b5-2 which illustrates when a duty of trust or confidence may arise under the misappropriation theory.[146] The SEC also issued the Regulations of Fair Disclosure (FD) to require prompt or immediate disclosure whenever the issuer or someone acting on its behalf selectively discloses material non-public information to outsiders.[147]

The U.S. corporate insider trading regulations lack a statutory definition of what constitutes "material non-public information."[148] However, the terminology of materiality was defined by the Supreme Court to mean when there is "a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available."[149] The SEC, in *the matters of Investors Management Co.*,[150] defined non-public information as "when it has not been disseminated in a manner making it available to investors generally."[151]

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[143] *15 U.S.C.A. § 78n*.
[144] For more discussion about this rule, *see infra* notes 646-59, 861-80, and 1092-109 and accompanying text.
[145] Rule 10b5-1, 17 C.F.R. §240. 10b5-1. *See infra* notes 1060-91 and accompanying text.
[146] Rule 10b5-2, 17 C.F.R. §240. 10b5-2. *See infra* notes 629-45 and accompanying text.
[147] Regulation FD, 17 C.F.R. §243. *See infra* notes 827-60 and accompanying text.
[148] *See infra* notes 915-17 and accompanying text.
[149] *Matrixx Initiatives, Inc. v. Siracusano*, 563 U.S. 27, 39 (2011) Citing *Basic Inc., v. Levinson,* 485 U.S. 224, 238 (U.S. 1988).
[150]Investors Management Co., Inc. ET.AL, 44 S.E.C., 633 (1971).
[151] *Id*. at 643. Citing S*.E.C. v. Texas Gulf Sulphur Co.*, 401 F.2d. 833, 854 (2d Cir. 1968), cert. denied, 394 U.S. 976 (1969). For more discussion about the definition of material non-public information, *see infra* notes 881-1020 and accompanying text.

II. Saudi Arabian Regulatory Framework

In Saudi Arabia, the subject of corporate insider trading is regulated by regulatory provisions under the Capital Market Law (CML) of the Kingdom of Saudi Arabia and its implementing regulations. Before discussing the regulatory framework of corporate insider trading, this section provides an introduction to Saudi Arabian securities regulations and sources of corporate insider trading provisions, and the Capital Market Authority (CMA) as the regulatory body authorized to administer and enforce the CML.

a. Saudi Arabian Securities Laws Framework

In 2003, King Fahd Al Saud issued Royal Decree Number M/3, promulgating the first unified law of the securities industry in the Kingdom of Saudi Arabia, the Capital Market Law (CML).[152] It governs the entire securities market in the Kingdom including the issuers and their insiders, Stock Exchange Market "TADAWUL," and authorized persons.[153] In addition to the CML, the securities market is governed by the implementing regulations issued by the CMA in accordance with Article (6)(2) of the CML.[154] The CMA has issued 26 implementing regulations for a wide range of aspects covered by the CML.[155] The regulations related to corporate insider trading matter are (1) Market Conducts Regulations of 2004 (MCR);[156] (2) the Rules on the Offer of Securities and Continuing

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[152] The Capital Market Law [CML], Royal Decree No. (M/30) dated 2/6/1424H (corresponding to July 31, 2003), https://cma.org.sa/en/RulesRegulations/CMALaw/Pages/default.aspx.

[153] *See* Joseph W. Beach, *The Saudi Arabian Capital Market Law: A practical Study of the Creation of Law in Developing Markets*, 41 Stan. J. Int'l L. 307, 20 (2005).

[154] CML, *id*, art. 6(2).

[155] *See* the website of Capital Market Authority: https://cma.org.sa/en/RulesRegulations/Regulations/Pages/default.aspx.

[156] Market Conduct Regulations [MCR], Board of the Capital Market Authority's decision No. 1-11-2004, dated 20/8/1425H (corresponding to Oct 10, 2004), amended by the Resolution No. 1-7-2018, dated 1/5/1439H (corresponding to Jan 18, 2018), https://cma.org.sa/en/RulesRegulations/Regulations/Documents/Market_Conduct_Regulations_En.pdf.

Obligations of 2017 (ROSCO);[157] (3) The Listing Rules of 2017 (LR);[158] and (4) Corporate Governance regulations of 2017 (CGR).[159] Furthermore, Islamic law, as a fundamental source of laws and regulations in Saudi Arabia, is the resort for judges when the rules and standards of the CML and CMA's implementing regulations are silent about an issue in dispute.[160] The CML does not allow bringing lawsuits against investors or related regulatory bodies before any courts in Saudi Arabia except the CMA's judicial body, the Committee for Resolution of Securities Disputes (CRSD), and the Appeal Committee for Resolution of Securities Disputes (ACRSD).[161] Article (25)(a) of CML states that the CMA:

> shall establish a committee known as the 'Committee for the Resolution of Securities Disputes' which shall have jurisdiction over the disputes falling under the provisions of

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[157] The Rules on the Offer of Securities and Continuing Obligations [ROSCO], Board of the Capital Market Authority's Resolution No. 3-123-2017, dated 9/4/1439H (Corresponding to Dec 27, 2017), amended by the Resolution No. 3-45-2018, dated 7/8/1439 (corresponding to April 23, 2018), https://cma.org.sa/en/RulesRegulations/Regulations/Documents/OSRCI_en.pdf.

[158] Listing Rules [LR of 2017], Board of the Capital Market Authority's Resolution No. 3-123-2017, dated 9/4/1439H (corresponding to Dec 27, 2017), amended by the Resolution No. 1-115-2018, dated 13/2/1440H, corresponding to Oct 22, 2018), https://goo.gl/MhzgzN.

[159] Corporate Governance Regulations [CGR], board of the Capital Market Authority's resolution No. 8-16-2017, dated 16/5/1438H (corresponding to Feb 13, 2017), amended by resolution No. 3-45-2018, dated 7/8/1439H (corresponding to April 23, 2018), *available at:* https://cma.org.sa/en/RulesRegulations/Regulations/Documents/CGRegulations_en.pdf.

[160] *See* Basic Law of Governance, Royal Decree No. (A/90) dated 27/8/1412H (corresponding to March 1, 1992) *available at*: https://www.boe.gov.sa/ViewSystemDetails.aspx?lang=en&SystemID=4&VersionID=240. (Article 7 of the Basic Law states that: "Government in the Kingdom of Saudi Arabia derives its authority from the book of god and the Sunnah of the prophet (PBUH), which are the ultimate source of reference for this Law and other laws of the state." *Id*. The supremacy of Islamic law status in Saudi Arabia is also emphasized in Article 48 of the Basic Law where it states that "the courts shall apply rules of Islamic Shari'ah in cases that are brought before them, according to the Holy Qur'an and the Sunna, and according to laws which are decreed by the ruler in agreement with the Holy Qur'an and the Sunna." *Id*. For more discussion about the constitutional law of the Kingdom of Saudi Arabia, *see* Ali M. Al-Mehaimeed, *The Constitutional System of Saudi Arabia*: *A Conspectus*, Arab L.Q. Vol. 8, No. 1, 30 (1993), available at: https://www.jstor.org/stable/3381491; Ayoub M. Al- Jarbou, *Judicial Independence: Case Study of Saudi Arabia*, Arab L.Q. Vol. 19, No. 1/4, 12 (2004), available at: https://www.jstor.org/stable/3382105. *See* also Zaid Mahayni, An Analysis of Capital Market Regulation in Saudi Arabia, 29 (2012) *available at* https://lra.le.ac.uk/bitstream/2381/28140/1/2012mahaynizphd.pdf.

[161] *See* Bushra Gouda & Ali Gouda, *The Saudi Securities Law Regulation of the TADAWUL Stock Market, Issuers, and Securities Professionals under the Saudi Capital Law of 2003*, 18 Ann. Surv. Int'l & Comp. L., 115, 19 (2012); *Beach*, *supra* note 153, at 328.

> this Law, its Implementing Regulations, and the regulations, rules and instructions issued by the Authority and the Exchange, with respect to the public and private actions.[162]

In addition, Article (25)(f) of the CML provides the right to appeal the Committees' decisions before the Appeal Panel, ACRSD, which is formed by a Council of Ministers' decision.[163] Paragraphs (g) and (h) of Article (25) state that the decisions of the ACRSD shall be final and enforced through the government agency responsible for the enforcement of judicial judgments.[164] It is noteworthy that judicial precedents in Saudi Arabia does not generally have a binding effect. However, the judicial decisions issued by the Saudi Arabian Appeal Committee for the Resolution of Securities Disputes typically carry a persuasive influence over lower committees.[165]

The general objectives of the CML are (1) creating a regulatory body with the power to administer, supervise and, enforce the CML; (2) establishing a national stock exchange and securities deposit center; (3) regulating the issuance of securities and the trading securities transactions; (4) defining the general standards that market participants must comply with to achieve "fairness, efficiency and transparency in securities transactions;" (4) regulating brokers; and (5) protecting investors from "unfair and unsound practices" by enacting anti-fraud, manipulation, and insider trading provisions.[166] The major characteristic of the CML is the extensive and sophisticated disclosure paradigm that has imposed upon issuers to ensure that investors are given enough and timely information

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[162] CML, *supra* note 152, art. 25(a).
[163] *Id*. art. 25(f), (g).
[164] *Id*. art. 25 (g), (h).
[165] The CRSD and ACRSD's decisions are published in the website of the General Secretariat of Committees for Resolution of Securities Disputes, https://crsd.org.sa/en/Pages/default.aspx.
[166] *See* CML, *supra* note 152, at art. 5; Mahayni, *supra* note 160, at 56.

for the purpose of promoting public confidence in the market.[167] The CML requires issuers to make full disclosure of specified information when securities are issued for the first time.[168] It also requires listed companies to provide quarterly and annual reports of certain information, including their financial condition, and managerial assessments.[169] The CML also requires issuers to continue to disclose all material developments as soon as such developments are discovered or occurred.[170]

b. <u>Capital Market Authority (CMA)</u>

The essential plan of enacting the CML was to be an enabling law that creates authorities to develop the Saudi stock market over subsequent years based on two main notions: administrative independence and professionalism.[171] Article (4)(a) of the CML created the CMA as an independent agency with legal status and financial and administrative autonomy.[172] In addition, it was given investigative and judicial powers.[173] The CMA was designated as the authority responsible for regulating and enforcing the CML.[174] It was granted large and flexible rulemaking powers that include regulating and developing the Exchange, to achieve the goals of the CML including (1) the protection of investors from unfair practices that involve "fraud, deceit, cheating or manipulation," and (2) achieving "fairness, efficiency and transparency in securities transactions."[175] To fulfill these goals, the CML granted the CMA the right to issue implementing regulations and to

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[167] *Beach, supra* note *153*, at 338.
[168] CML, *supra* note 152, arts. 40-44.
[169] *Id*. art. 45.
[170] *Id*. art. 46(a). *See Beach, supra* note *153*, at 341.
[171] *Beach, supra* note *153*, at 320.
[172] CML, *supra* note 152, art. 4(a). *See Beach, supra* note *153*, at 341; Mahayni, *supra* note 160, at 66; *Gouda*, *supra* note 161, at 121.
[173] *See id*. arts. 5(c), 59(b).
[174] *See id*. arts. 5-6.
[175] *Id*. art. 5.

amend them to enforce the provisions of the CML.[176] Although the CML granted the CMA vast rulemaking power to issue implementing regulations and develop its oversight of the capital market, the CML did not give the CMA the right to amend the provisions of the CML. These provisions describe the fundamental boundaries that the CMA's implementing regulations shall comply with and serve to apply.[177]

c. <u>Companies Law</u>

Public listed companies in the national exchange of Saudi Arabia, the Saudi Stock Exchange (Tadawul), must have the form of a joint-stock company (JSC).[178] A JSC is a company in which its capital "shall be divided into negotiable shares of equal value" where the shareholders' liability is limited to the value of their shares, and the company is "liable for debts and liabilities arising from its activities."[179] The legal relationship between a JSC's insiders, directors and executives, and the company along with its shareholders is governed by the Companies Law of 2015 (CL of 2015). This is the primary law that governs the life-cycle of a JSC including the incorporation rules, and the directors and managers' duties and shareholders' rights.[180] Public JSCs that are listed in the Exchange are also governed by the CML and its implementing regulations issued by the CMA, in particular, CGR.[181] This regulation describes the standards and rules that govern the management of listed companies in addition to the rules stated in the CL of 2015.[182] Judges

[176] *Id*. art. 6(2).
[177] *Beach, supra* note *153*, at 326.
[178] ROSCO, *supra* note 157, art. 24(1).
[179] Companies Law [CL of 2015], Royal Decree No. (M/3) dated 28/1/1437H (corresponding to Nov 11, 2015), *available at* https://boe.gov.sa/ViewSystemDetails.aspx?lang=en&SystemID=373&VersionID=352. *See* Mohammed Al-Jaber, *Al-Qanun Al-Tijari Al-Saudi [The Saudi Commercial Law]*, 289 (4th ed. 1996).
[180] *See id*. arts. 52-150; Abdulhadi Al-Ghamdi, *Al-Qanun Al-Tijari Al-Saudi (The Saudi Commercial Law)*, 310 (2nd ed. 2017).
[181] *See* ROSCO, *supra* note 157, art. 24(1); CGR, *supra* note 159.
[182] *Id*. arts. 1, 2.

are required to fill in the gaps of the written regulations based on Islamic law, as a fundamental source of laws and regulations in Saudi Arabia.[183]

d. Regulatory Framework of Corporate Insider Trading

The source of corporate insider trading regulations are statutory provisions and administrative articles. Article (68) of the ROSCO and Article (33) of the LR of 2017 require companies' insiders, directors, senior executives, and substantial shareholders, who hold 5 percent or more of any class of voting shares or convertible debt instruments of an issuer, to disclose their securities ownership and any change in their percentage of ownership that resulted after trading transactions.[184] Article (69) of the ROSCO also imposes upon companies' directors and senior executives lock-up periods preceding the announcement of quarterly and annual reports.[185]

The source of the prohibition of illegal corporate insider trading is Article (50) of the CML.[186] Article (50) of the CML prohibits corporate insiders and other statutory insiders who obtain inside information through a family, business or contractual relationship from trading in the related security or disclosing such information to trade in the related security.[187] It also prohibits outsiders from trading on inside information obtained from insiders.[188] It defines the meaning of inside information and the prohibited conduct in addition to the requisite state of mind.[189] Article (50) reads:

> (a) Any person who obtains, through family, business or contractual relationship, inside information (hereinafter an "insider") is prohibited from directly or indirectly trading in

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[183] *See supra* note 160 and accompanying text.
[184] ROSCO, *supra* note 157, art. 68; LR of 2017, *supra* note 158, art. 33. *See infra* notes 1332-90 and accompanying text.
[185] ROSCO, *id*. art. 69. *See infra* notes 1449-63 and accompanying text.
[186] CML, *supra* note 152, art. (50).
[187] *See infra* notes 1478-529 and accompanying text.
[188] Se *infra* notes 1548-93 and accompanying text.
[189] *See infra* notes 1594-1714 and accompanying text.

> the Security related to such information, or to disclose such information to another person with the expectation that such person will trade in such Security. Insider information means information obtained by the insider and which is not available to the general public, has not been disclosed, and such information is of the type that a normal person would realize that in view of the nature and content of this information, its release and availability would have a material effect on the price or value of a Security related to such information, and the insider knows that such information is not generally available and that, if it were available, it would have a material effect on the price or value of such Security.
> (b) No person may purchase or sell a Security based on information obtained from an insider while knowing that such person, by disclosing such insider information related to the Security, has violated paragraph (a) of this Article.[190]

In November 2004, the CMA promulgated the MCR,[191] which includes three articles defining and specifying the provisions of Article (50)(a) and (b) of the CML, pursuant to Article 50(c) which authorized the CMA to "establish the rules for specifying and defining the terms provided for under paragraphs (a) and (b) of this Article…"[192]

Article (4) of the MCR defines a security related to inside information as any traded security whose price would be materially affected if the inside information were disclosed or made available to the public.[193] It also defines who is an insider which includes companies' insiders and outsiders who misappropriate confidential information obtained through a family, business, or contractual relationship. Inside information is defined as information that has not been disclosed to the public, and information that a normal person would realize in view of the nature and content of the information that disclosing it or making it available to the public would have a material effect on the price or value of the security.[194] Article (5) of the MCR prohibits disclosure of inside information to outsiders where the disclosing person was an insider or an outsider obtained the information from an

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[190] CML, *supra* note 152, art. 50.
[191] *See* MCR, *supra* note 156.
[192] CML, *supra* note 152, art. 50(c).
[193] *See infra* notes 1594-682 and accompanying text.
[194] MCR, *supra* note 156, art. 4(a), (b), and (c).

insider.[195] Article (6) provides a provision for the general prohibition on insiders and outsiders engaging in trading on inside information against insiders and outsiders.[196]

[195] *Id*. art. 5(a), (b).
[196] *Id*. art. 6(a), (b).

Chapter 2. U.S. Corporate Insider Trading Regulations

Introduction

This chapter examines the U.S. corporate insider trading regulations by dividing the chapter into five parts. Part 1 describes the legal status of corporate insiders in the United States to understand why corporate insiders are a special class of traders. Part 2 examines the U.S. regulations and restrictions of corporate insider trading under Section 16 of the SEA. Part 3 focuses on the regulations governing illegal corporate insider trading. Part 4 examines the governmental enforcement of the prohibition of illegal corporate insider trading. Part 5 is a summary and concluding remarks of this chapter.

Part 1. Legal Status of Corporate Insiders—Fiduciary Duty

Introduction

The main characteristic of corporate insiders in the United States is that they occupy a fiduciary position requiring them to solely act to further the interests of the corporation and to refrain from conducts that is in conflicts with this duty, including self-dealing and unjust-enrichment that arises from the wrongful use of the property of the corporation or its business. The principal ground for restrictions of U.S. corporate insider trading is based on the notion that corporate insiders as fiduciaries are entrusted to control and serve the corporation and should not breach their fiduciary duty when they trade in the corporation's security.[197] In addition, the U.S. prohibition from illegal corporate insider trading has been linked to outsiders who are subject to fiduciary or similar relations of trust and confidence. This makes the notion of fiduciary duty at the heart of illegal corporate insider trading regulations.

[197] *See infra* note 265 and accompanying text.

This part defines the term "fiduciary" and how a fiduciary relationship is formulated. It then describes the legal status of corporate insiders and their general duties as fiduciaries under state corporate law.

<u>Definition of Fiduciary</u>

The word "fiduciary" is derived from the Latin word "fiduciarius," from "fiducia" which means confidence and trust.[198] The word "trust" in earlier times was not restricted to the narrow meaning of trust of property as used today,[199] but it included other relationships that involve reposing confidence and trust by a person upon another.[200] When the English Court of Chancery[201] recognized the word "trust" as a legal term,[202] other similar relationships that did not meet the strict definition of "trust" were labeled "fiduciary relationships."[203] Professor Deborah A. DeMott describes the origin of the legal definition of the word "fiduciary" as follows:

> As a legal principle, the [fiduciary] obligation originated in Equity…As Equity evolved, concrete rules in many instances supplanted the chancellors' exercise of discretion based on broad principles; established usages for terms like "trust" and "confidence" replaced an earlier and imprecise vocabulary. The term "fiduciary" itself was adopted to apply to

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[198]Merriam-Webster's website, *Fiduciary*, (last updated Dec 28, 2018), available at: https://www.merriam-webster.com/dictionary/fiduciary.

[199] The Restatement (Third) of Trusts defines trust as "a fiduciary relationship with respect to property, arising from a manifestation of intention to create that relationship and subjecting the person who holds title to the property to duties to deal with it for the benefit of charity or for one or more persons, at least one of whom is not the sole trustee." RESTATEMENT (THIRD) OF TRUST, §2 (2003).

[200] L.S. Sealy, *Fiduciary Relationship*, 1962 Cambridge L.J. 69 (1962); *See* also AUSTIN WAKEMAN SCOTT, THE LAW OF TRUST, §2., 2d ed. (1956).

[201] The Court of Chancery is "A court of equity…derived from the court of the Lord Chancellor, the Original English Court of equity." Black's Law Dictionary, (10th ed. 2014). ("'Chancery's jurisdiction was complementary to that of the courts of common law—it sought to do justice in cases for which there was no adequate remedy at common law." *Id*, quoting A.H. Manchester, *Modern Legal History of England and Wales*, 1750-1950, 135-36 (1980).

[202] For more information about the development of Trust, *see* SCOTT, *supra* note 200, at §1.1.

[203] *Sealy*, *supra* note 200, at 71; SCOTT, *supra* note 200, at *§2.* For more discussion about the history of trust and fiduciary relationships, *see* David J. Seipp, *Trust and Fiduciary Duty in the Early Common Law*, http://www.bu.edu/law/journals-archive/bulr/documents/seipp.pdf.

situations falling short of "trusts," but in which one person was nonetheless obliged to act like a trustee." [204]

Fiduciary relationships have gradually been recognized over several centuries and are found under several laws, such as the law of trust, agency, and partnerships and corporations.[205] Therefore, several commentators argue that the justification of imposing fiduciary relationships by the courts is inconsistent, since it lacks an inclusive definition that could generally differentiate fiduciary from non-fiduciary relationships.[206] However, courts often refuse to provide an inclusive definition of fiduciary relationships.[207] This rejection may be based on the notion that the articulation of one inclusive definition for fiduciary relationships is unwarranted because of the unique characteristics of each fiduciary relationship under its related law. Moreover, formulating one definition would be

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[204] Deborah A. DeMott, *Beyond Metaphor: An Analysis of Fiduciary Obligation*, 1988 Duke L.J. 879, 880 (1988).

[205] Tamar Frankel, *Fiduciary Law*, 71 Cal. L. Rev. 795, 797 (1983), available at: https://scholarship.law.berkeley.edu/californialawreview/vol71/iss3/1/.

[206] DOBBS DAN B ET AL., HORNBOOK ON TORTS, 1143, (2nd ed. 2016); *DeMott*, *supra* note 204; Frankel, *supra* note 205. at 804.

[207] *See* for e.g., *Warsofsky v. Sherman*, 326 Mass. N.E.2d 290, 292-93 (1950). ("Similar situations for the circumstances which may create a fiduciary relationship are so varied that it would be unwise to attempt the formulation of any comprehensive definition that could be uniformly applied in every case."); *M.L. Stewart& Co. v. Marcus*, 207 N.Y.S. 685, 689 (1924). ("The principles applicable to the more familiar relations of this character have been long settled by many well-known decisions, but the courts have always been careful not to fetter this useful jurisdiction by defining the exact limits of its exercise."); *Alaimo v. Royer*, 188 Conn. 36, 41 (1982). ("This court has, however, specifically refused to define 'a fiduciary relationship in precise detail and in such a manner as to exclude new situations,' choosing instead to leave 'the bars down for situations in which there is a justifiable trust confided on one side and a resulting superiority and influence on the other.'"); *Abbitt v. Gregory*, 201 N.C. 577, 896, 906 (1931). ("The courts generally have declined to define the term 'fiduciary relation" and thereby exclude from this broad term any relation that may exist between two or more persons with respect to the rights of persons or property of either.'") *Reebles Inc. v. Bank of America*, N.A., 29 Kan.App.2d, 205, 209 (2001) ("[The] fiduciary relationship exists depends on the facts and circumstances of each individual case. The Kansas Supreme Court has refused for that reason to give an exact definition to fiduciary relationships.") For more discussion, please *see Frankel*, *supra* note 205, at 804; *DeMott*, *supra* note 204, at 879; D. Gordon Smith, *The Critical Resource Theory of Fiduciary Duty*, 55 Vand. L. Rev. 1399, 1413 (2002).

at the expense of the current flexible judicial approach, and it could hinder the court's recognition of new types of fiduciary relationships.[208]

Commentators offer several definitions of fiduciary relationships to rationalize and justify the application of fiduciary principles on new relationships.[209] One of the recent attempts to define fiduciary relationships by Professor D. Gordon Smith focuses on the discretional use that the fiduciary has after the formation of a fiduciary relationship. Professor Smith concludes that: "Fiduciary relationships form when one party ('the fiduciary') acts on behalf of another party (the 'beneficiary') while exercising discretion with respect to a critical resource belonging to the beneficiary."[210] Another definition by Professor Deborah A. DeMott bases the definition on finding a justifiable expectation of loyalty.[211] Professor DeMott finds that the "defining or determining criterion should be whether the plaintiff (or claimed beneficiary of a fiduciary duty) would be justified in expecting loyal conduct on the part of an actor and whether the actor's conduct contravened that expectation."[212]

Courts now divide fiduciary relationships into two categories: (1) well-established fiduciary relationships, termed conventional or formal fiduciary relationships, such as the relationships between the trustee and beneficiary, agent and principal, attorney and client, partner and fellow partners in partnerships, guardian-ward, and directors and corporation[213]; and (2) a new type of relationship, termed informal fiduciary relationships

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[208] *See Frankel*, *supra* note 205, at 797; *See id*.
[209] For more discussion about other attempts by commentators to define fiduciary relationships, *see*, *Smith*, *supra* note 207, at 1423; *DeMott*, *supra* note 204, at 908.
[210] *Smith*, *supra* note 207, at 1402.
[211] Deborah A. DeMott, *Breach of Fiduciary Duty: On Justifiable Expectations of Loyalty and Their Consequences*, 48 Ariz. L. Rev. 925, 936 (2006).
[212] *Id*.
[213] *Frankel*, *supra* note 205, at 797.

or confidential relationships, in which the courts impose fiduciary principles on them "due to the factual situation surrounding the involved transactions and the relationship of the parties to each other and to the questioned transactions."[214] The courts treat conventional fiduciary relationships as being fiduciary by nature, and determine whether a relationship warrants the application of fiduciary principles on a case-by-case basis.[215] Courts merely analogize the new relationship to one of the "well-established" fiduciary relationships that is functionally similar to the new type. Then, they apply the rules of that conventional relationship to the new type of relationship.[216]

In their analysis, courts consider several factors or characteristics of the relationship under review to decide whether this new relationship warrants the imposition of fiduciary principles. However, none of these factors is absolute or determinative. A mutual test that

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[214]*See Martinez v. Associates Financial Services Co. of Colorado, Inc*., 891 P.2d 785, 789(Wyo. 1995) ("Of the two essential kinds of fiduciary relationships, the first arises from specific legal relationships. 'In cases of trustee and beneficiary, principal and agent, and the like, the relations are essentially fiduciary, and the inference or presumption follows of course.'…The second is less susceptible of exact definition, being 'implied in law due to the factual situation surrounding the involved transactions and the relationship of the parties to each other and to the questioned transactions."); *Warsofsky v. Sherman*, 326 Mass. N.E.2d, 290, 292-93 (1950) ("There are many familiar and well recognized forms of fiduciary relationships such as attorney and client, trustee and beneficiary, physician and patient, business partners, promoters or directors and a corporation, and employer and employee."); *Wilson v. IBP, Inc*., 558 N.W.2d 132, 138 (Iowa. 1996). ("Fiduciary duties arise as a matter of law in certain formal relationships, including attorney-client, partnership, and trustee relationships... Outside of the cases in which formal fiduciary duties arise as a matter of law, confidential relationships may arise when the parties have dealt with each other in such a manner for a long period of time that one party is justified in expecting the other to act in its best interest."); R*eebles, Inc. v. Bank of America, N.A.*, 29 Kan. App.2d 205, 209 (2001). ("Generally, there are two types of fiduciary relationships: (1) those specifically created by contract or by formal legal proceedings and (2) those implied in law due to the factual situation surrounding the involved transactions and the relationship of the parties to each other and to the questioned transactions. The determination of the existence of a fiduciary relationship in the second category is more difficult to determine."); *Swenson v. Bender*, 764 N.W.2d 596, 601 (Minn. Ct. App. 2009). "Minnesota caselaw recognizes two categories of fiduciary relationship: relationships of a fiduciary nature per se, and relationships in which circumstances establish a de facto fiduciary obligation… Per se fiduciary relationships include trustee-beneficiary, attorney-client, business partnerships, director-corporation, officer-corporation, and husband-wife."). *See* Smith, *supra* note 207, at 1412; *DeMott*, *supra* note 211, at 956; and *Frankel*, *supra* note 205, at 804.

[215]Jack Peggs & Kevin B. Johnson, *Fiduciary Fraud*, 121 Am. Jur. Trials 129, §5. (2011) Westlaw (database updated May. 2018).

[216] *See Frankel*, *supra* note 205, at 804.

many courts use in their analysis is "(1) 'trust' or 'confidence' reposed by one person in another; and (2) the resulting 'domination', 'superiority', or 'undue influence' of the other."[217] Or when "a special confidence reposed in one who in equity and good conscience is bound to act in good faith and with due regard to the interest of the one reposing confidence."[218] Other factors the court may consider include the past history of the relationship between the parties, the inequality between the parties, such as mental, knowledge, age, and other conditions that may give one party an advantage over another.[219]

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[217] Smith, *supra* note 207, at 1413; *See* for e.g., *Alaimo v. Royer*, 188 Conn., 36, 41 (1982). ("This court has, however, specifically refused to define "a fiduciary relationship in precise detail…choosing instead to leave 'the bars down for situations in which there is a justifiable trust confided on one side and a resulting superiority and influence on the other.'"); *Lopacich v. Falk,* 5 F.3d 210, 213-14 (7th Cir. 1993). ("In order to establish evidence of a fiduciary relationship, the plaintiff must show that she reposed confidence in the defendant and that he had influence and superiority over her."); *Swenson v. Bender*, 764 N.W.2d, 596, 601 (Minn. Ct. App. 2009) ("Fiduciary relationships arise when one person trusts and confides in another who has superior knowledge and authority.").

[218] *Abbitt v. Gregory*, 201 N.C. 577, 896, 906 (1930) ("The relation may exist under a variety of circumstances; it exists in all cases where there has been a special confidence reposed in one who in equity and good conscience is bound to act in good faith and with due regard to the interests of the one reposing confidence."); *see also*, *Schmidt v. Bishop*, 779 F. Supp. 321, 326 (S.D.N.Y.1991). ("Broadly stated, a fiduciary relationship is one founded upon trust or confidence reposed by one person in the integrity and fidelity of another. It is said that the relationship exists in all cases in which influence has been acquired and betrayed."); *Bloomfield v. Nebraska States Bank*, 237 Neb. 89, 96 (1991). ("[A confidential] relationship exists between two persons if one has gained the confidence of the other and purports to act or advise with the other's interest in mind."); *Bolton v. Crowley, Hoge & Fein, P.C.*, 110 A.3d 575, 584 (D.C. 2015). ("A fiduciary relationship is founded upon trust or confidence reposed by one person in the integrity and fidelity of another."; *Peggs & Johnson*, *supra* note 215, at §5.

[219] *See Broomfield v. Kosow*, 349 Mass. 749, 755 (1965). "In redressing an abuse of trust and confidence equity will review such factors as the relation of the parties prior to the incidents complained of, the plaintiff's business capacity or lack of it contrasted with that of the defendant, and the readiness of the plaintiff to follow the defendant's guidance in complicated transactions wherein the defendant has specialized knowledge. Equity will, in sum, weigh whether unjust enrichment results from the relationship."); *Bishop*, 779 F. Supp, at 325. ("Such a relationship might be found to exist, in appropriate circumstances, between close friends ... or even where confidence is based on prior business dealings....") *Id*; *Insurance Co. of North America v. Morries*, 981 S.W.2d 667, 674 (Tex. 1998). ("Outside of the cases in which formal fiduciary duties arise as a matter of law, confidential relationships may arise when the parties have dealt with each other in such a manner for a long period of time that one party is justified in expecting the other to act in its best interest.") *Id*. For more discussion about the courts' analysis, *see*, *DeMott*, *supra* note 211, at 936; STUART M. SPEISER ET AL, AMERICAN LAW OF TORTS, §32:81 Westlaw (database updated Mar. 2018); *Peggs & Johnson*, *supra* note 215, at §5; Robert A. Kutcher, *Breach of Fiduciary Duties*, *available at* American Bar Association, https://apps.americanbar.org/abastore/products/books/abstracts/5310344_chap1_abs.pdf.

Two caveats must be mentioned here. First, confidential relations are not always fiduciary relationships.[220] Non-fiduciary confidential relationships can be found in several situations such as, when there is a confidential relation between parties arising from a contractual relationship,[221] or from family[222] or friendship relationships.[223] Second, if federal action, state legislation, or courts recognize a new type of relationship as a fiduciary relationship, it does not mean this new relationship would be recognized as fiduciary in other U.S. states.[224]

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[220] SCOTT, *supra* note 200, at §2.5. It should be notable that courts sometimes use the terms "fiduciary relationships" and "confidential relationships" interchangeably without distinguishing between them. *See Frankel*, *supra* note 205, at 825.

[221] Black's Law Dictionary (10th ed. 2014) ("A confidential relationship can be expressly established, as by the terms of an employment contract. It can also be implied when one person knows or should know that the information is confidential, and the other person reasonably believes that the first person has consented to keep the information confidential. A confidential relationship might be implied, for instance, between two people negotiating the sale of a business.") *Id*.

[222] SCOTT, *supra* note 200, at §2.5. ("A fiduciary relation is to be distinguished from a merely confidential relation…it is particularly likely to exist where there is a family relationship…" *Id*; *Frankel*, *supra* note 205, at 825. Economopoulos v. Kolaitis, 259 Va. 806, 812 (Vir.2000). ("A parent-child relationship, standing alone, is insufficient to create a confidential or fiduciary relationship." *Fix v. Fix*, 847 S.W.2d 762, 765 (Mo. 1993). ("A confidential, or fiduciary, relationship is not proven merely by a showing that the persons have ties of blood or family.") *Id*; *Olson v. Harshman*, 668 P.2d 147, 151 (Kan. 1983) ("The mere relationship of parent and child does not raise a presumption of a confidential and fiduciary relationship....") *Id*.

[223] Restatement (Third) of Trusts § 2 (2003). ("A confidential relation may exist although there is no fiduciary relation and is particularly likely to arise between family members or close friends…") *Id*; *Smith*, *supra* note 207, at 1411; *Smith v. Walden*, 549 S.E.2d 750 (Ga. 2001). ("mere friendship and close fellowship, without more, do not create a fiduciary relationship.") *Id*.

[224] The best example is the relationship between a husband and wife. In some states their relationship, without more, is not a fiduciary relationship, and other states find this martial relationship by itself a fiduciary relationship. For example, *see Lasater v. Guttmann,* 5 A.3d 79, 94 (Md.2010). ("In Maryland, a husband and wife are not true fiduciaries, as a matter of law, absent an agreement establishing that relationship… while there are some relationships that are presumed confidential, 'otherwise, and particularly in family relationships, such as parent-child and husband-wife, the existence of a confidential relationship is an issue of fact and is not presumed as a matter of law.'") *Id*; *Nessler v. Nessler*, 902 N.E.2d 701, 708 (NC. 2008). ("While a marital relationship alone may not establish a fiduciary relationship, a fiduciary relationship may arise in a marital relationship as the result of special circumstances of the couple's relationship, where one spouse places trust in the other so that the latter gains superiority and influence over the former…") *Id*; *Swenson v. Bender*, 764 N.W.2d, 596, 601 (Minn. Ct. App. 2009). ("Per se fiduciary relationships include trustee-beneficiary, attorney-client…, and husband-wife.") *Id*; *Bedrick v. Bedrick*, 17 A.3d 17, 26 (Conn.2011). ("Spouses have 'confidential relationship' and 'stand as fiduciaries to each other'… It includes, but is not limited to, a fiduciary duty between the spouses, of the highest degree.") *Id*; *Charlton v. Charlton*, 413 S.E.2d 911, 911 (W.Va.1991) ("The relationship between husband and wife is one of confidence and trust.") *Id*. *See* Francis C. Amendola et al., 41 C.J.S. Husband and Wife §3, Westlaw (Database updated June. 2018).

Fiduciary Principles

In corporate law, courts have used the principles of fiduciary in agency[225] and trust[226] relationships as prototypes or models to form the principles of fiduciary relationships.[227] They share similar characteristics but have some differences.[228] However, all fiduciaries, including trustees and agents, are subject to the duty "to act with the highest degree of honesty and loyalty toward another person and in the best interests of the other person."[229] The fiduciary duty can be divided into the duty of care and duty of loyalty.[230] The intensity of the fiduciary duty depends on the type of fiduciary relationship and the power that a fiduciary is delegated to exercise.[231] In general, the fiduciary duty of loyalty is the core principle that differentiates fiduciary relationships from non-fiduciary relationships.[232] It is the duty that forbids a fiduciary, within the scope of the relationship

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[225]The Restatement (Third) of Agency states that "Agency is the fiduciary relationship that arises when one person (a "principal") manifests assent to another person (an "agent") that the agent shall act on the principal's behalf and subject to the principal's control, and the agent manifests assent or otherwise consent so to act." *Id*. at §1.01 (2006). *See Frankel*, *supra* note 205, at 805.

[226] *See supra* note 199.

[227] *Frankel*, *supra* note 205, at 805.

[228] *See* SCOTT, *supra* note 200, at §8. (The differences between a trustee and an agent include (1) the trustee is not appointed by the beneficiary and is not subject to the control of the beneficiary. In contrast, the agent is appointed by the principal and subject to his control; (2) The trust cannot be terminated at the will of the beneficiary, but the principal has the power to terminate the agency relationships at his will; The trustee has title to the trust property; The agent usually does not have title to the property of the principal.) *Id*.

[229] Black's Law Dictionary (10th ed. 2014); *Swenson v. Bender*, 764 N.W.2d, 596, 601 Minn. Ct. App. 2009) at *supra* note 16. ("The duty imposed on fiduciaries is the highest standard of duty implied by law.").

[230] The Restatement (Third) of Trusts states that: "The trustee has a duty to administer the trust, diligently in good faith, in accordance with the terms of the trust and applicable law…" *Id*, at §76. The Restatement (Third) of Agency states that: "[A]n agent has a duty to the principal to act with the care, competence, and diligence normally exercised by agents in similar circumstances…" *Id*, at §8.08 The Restatement (Third) of Trusts states that: "A trustee has a duty to administer the trust solely in the interest of the beneficiaries, or solely in furtherance of its charitable purpose." §78 (2007). The Restatement (Third) of Agency states that: "An agent has a fiduciary duty to act loyally for the principal's benefit in all matters connected with the agency relationship." *Id*. §8.01. (2006).

[231] Austin W. Scott, *The Fiduciary Principle*, 73 Cal. L. Rev. 539, 541 (1949).

[232] The duty of care is not distinctively attached to the fiduciary principles. Professor Deborah A. DeMott finds that fiduciary duty of care "is not distinctively fiduciary; many persons, by virtue of the law or their own contractual undertakings, owe duties of care to other persons with whom they have non-fiduciary relationships. For example, motorists owe duties of care to pedestrians and to fellow motorists but are not,

with the beneficiary, from "self-dealing…and other forms of self-advantaging conduct without the beneficiary's consent."[233] It is an obligation that fiduciaries must act with the highest standard of fidelity for the benefit of the person for which these fiduciaries act.[234] All fiduciaries must put their personal interest aside while acting in fiduciary capacity within the scope of their relationships.[235] When they transact with whom they act, they must be "candid" and demonstrate utmost "good faith" by providing full disclosure about any material information regarding the transaction, or the transaction may be void.[236] Justice Cardozo illustrates this principle by ruling that: "Many forms of conduct permissible in a workaday world for those acting at arm's length, are forbidden to those bound by fiduciary ties."[237] Moreover, the duty of loyalty requires fiduciaries to not misappropriate the property entrusted to them including using confidential information for their personal benefit, or to communicate such information to others.[238] Whatever the

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by virtue of these relationships, under any fiduciary constraint in their pursuit of self-interest!" *DeMott*, *supra* note 204, at 879. *See* also, *Smith*, *supra* note 207, at 1409.

[233] *DeMott*, *supra* note 211, at 926.

[234] *Peggs & Johnson*, *supra* note 215, at §6. Professor Victor Brudney explains that: "the notion is that the fiduciary's duty of loyalty requires the trustee or agent to act as the beneficiary's (or principal's) alter ego and act only as the latter would act for himself. At least as between the fiduciary's interest and the beneficiary's interest the fiduciary is to serve only the latter." *Contract and Fiduciary Duty in Corporate Law*, 38 B.C. L. Rev. 595, 601 (1997).

[235] Robert W. Hallgring comments about the fiduciary duty of loyalty by asserting that: "Given human frailty, we cannot expect the fiduciary to put his personal advantage in second place…From this observation it follows that undivided and disinterested devotion by one person to the interest of another will be assured only where the possibility of conflicting interest is excluded…the exclusion of conflicting interests will be assured only when all possibilities of personal profit have been eliminated." *The Uniform Trustees' Powers Act and the Basic Principles of Fiduciary Responsibility*, 41 Wash. L. Rev. 801, 803 (1966).

[236] Austin Wakeman Scott states that: "As to matters within the scope of the relation he [the fiduciary] is under a duty not to profit at the expense of the beneficiary. If the fiduciary enters into a transaction with the beneficiary and fails to make a full discourse of all circumstances known to him affecting the transaction, or if the transaction with the beneficiary is unfair to the beneficiary, it can be set aside by him" SCOTT, *supra* note 200, at §2.5, §2.3. *See DeMott*, *supra* note 204, at 908*, 882.*

[237] *Meinhard v. Salmon*, 249 N.Y. 458, 463–64, 164 N.E. 545, 546 (1928).

[238] *See William A.,* GREGORY, LAW OF AGENCY AND PARTNERSHIP, 13 (3rd ed. 2001); Scott, *supra* note 231, at 55. The Restatement (Third) of Agency states that: "An agent has a duty (1) not to use property of the principal for the agents' own purpose or those of a third party; and (2) not to use to communicate confidential information of the principal for the agent's own purpose of those of a third party" *Id*. at §8.05. (2006).

conduct of the breach of fiduciary duty, directors or other fiduciaries would be deemed liable of "tortuous conduct" toward the corporation for such a breach.[239] Notice that if the breach was to gain personal benefit that involves taking advantage of the fiduciary position, the breach can also be termed fiduciary fraud or constructive fraud.[240]

Nonetheless, the fiduciary duty of loyalty is a "residual concept" that cannot be narrowed down to specific situations upon which a breach of this duty is recognized. Indeed, courts and statutes seek to provide "bright-line" obligations that address reoccurring situations involving conflict of interest and self-dealing matters.[241]

<u>Fiduciary Position of Corporate Insiders and to Whom the Duty is Owed</u>

In the world of business, a corporation, as an artificial entity that only acts through natural persons, needs to hire employees and professionals to function including low-level employees, managers, directors, or advisors. The corporation needs to delegate power to these professionals to use its funds and assets for its interest.[242] However, the authorized

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[239] The Restatement (Second) of Tort § 874, comment (b) (1979).

[240] Robert S. Schwartz, *SEC Rule 10b-5: Contrastive Fraud and the Liabilities of Fiduciaries*, 35 Ohio St. L.J. 934, 936 (1974); *Peggs & Johnson*, *supra* note 215, at §4. Delaware Court of Chancery states that the concept of constructive fraud is "an ill-defined one, but generally exists to prevent wrongdoing by someone who occupies a special position of confidence or trust, such as that of a fiduciary. Our corporate case law has thrown this concept around in a not particularly precise way, but always in a context in which the court is examining whether directors have complied with their fiduciary duties." *Carsanaro v. Bloodhound Techs., Inc.,* 65 A.3d 618, 643 (Del. Ch. 2013). Citing *Parfi Holding AB v. Mirror Image Internet, Inc,* 794 A.2d. 1211, 1235 (Del. Ch. 2001). *See also Eggleston v. Kovacich*, 742 N.W.2d 471, 482 (Neb. 2007) (Constructive fraud generally stems from a breach of duty arising out of a fiduciary or confidential relationship.) *Id*. The difference between actual fraud and constructive fraud is that constructive fraud requires a fiduciary or confidential relationship as an element of the claim, but actual fraud does not require such relationship. Constructive fraud does not require showing intent to defraud or reliance other than relying on the confidence and trust of the fiduciary. In contrast, actual fraud requires showing of intent to defraud and reliance. *See Peggs, & Johnson*, *supra* note 215, at §7.

[241] ROBERT CHARLES CLARK, CORPORATE LAW, 141 (1986); F. Hodge O'Neal & Robert B. Thompson, O'Neal and Thompson's Oppression of Minority Shareholders and LLC Members, §7:3., Westlaw (database updated May. 2018).

[242] *See DeMott*, *supra* note 204, at 908*, 917*; *Prairie Capital III, L.P. v. Double E Holding Corp*., 132 A.3d 35, 59-60 (Del. Ch. 2015). ("A corporation is an artificial being, invisible, intangible, and existing only in contemplation of law. Being a purely metaphysical creature, having no mind with which to think, no will with which to determine and no voice with which to speak, a corporation must depend upon the faculties of

use of the corporation's property comes with an opportunity to abuse their delegated power. Therefore, the principle of fiduciary duty becomes an important role in organizing and governing the relationship between corporations and those professionals.[243]

In the realm of corporate law, directors, officers, and to some extent, majority shareholders have a fiduciary duty to the corporation and shareholders.[244] Directors are in a *sui generis* fiduciary relationship with the corporation[245] since directors are not trustees or agents of the corporation and shareholders.[246] Although they conduct a similar function to trustees and agents by acting for the benefit of another—the corporation and shareholders—they are distinguished from trustees and agents in several aspects. For example, they are elected by the shareholders, which differentiates them from trustees. They are free from shareholders' control in managing the corporation, which differentiates

natural persons to determine for it its policies and direct the agencies through which they are to be effectuated. Because it lacks a body and mind, a corporation only can act through human agents.") *Id*. *See* FRANCIS C. AMENDOLA ET AL, 18 C.J.S. CORPORATIONS § 7, Westlaw (database updated June 2018).

243 For more discussion about the connection between the theory of the economic firm and fiduciary principles, *see Smith*, *supra* note 207, at 1431. (Professor Smith illustrates that "[T]he thesis of [] [his] Article is that fiduciary duties are imposed in relationships that have attributes similar to an economic firm. While some fiduciary relationships do not qualify as 'firms'-a term that is limited to commercial enterprises-all share a common structure.") *Id*. *See also Frankel*, *supra* note 205, 807. ("This Article shows that all fiduciary relations give rise to the problem of abuse of power, that the purpose of fiduciary law should be to solve this problem, and that the differences in the rules applicable to various fiduciary relations stem from differences in the extent of the problem.") *Id*.

244 CLARK, *supra* note 241, at 141; *Auriga Capital Corp. v. Gatz properties*, 40 A.3d 839, 850 (Del. Ch. 2012). ("Corporate directors, general partners and trustees are analogous examples of those who Delaware law has determined owe a 'special duty.' Equity distinguishes fiduciary relationships from straightforward commercial arrangements where there is no expectation that one party will act in the interests of the other.") *Id*. *See* O'NEAL & ROBERT, *supra* note 241, at §7:3.

245 HAMILTON ET AL, *supra* note 111, at 363.

246 *See id*; FREER & MOLL, *supra* note 117, at 270-71.

them from agents.[247] In turn, corporate officers' fiduciary duty is simply derived from the law of agency.[248]

Shareholders of a corporation, in general, have no fiduciary duty owed to their corporations or to one another.[249] They are free to act in their personal interest, disregarding the interest of the corporation or other shareholders.[250] However, controlling or majority shareholders must carry out fiduciary obligations toward the corporation and minority shareholders.[251]

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[247] For more discussion about this issue, *see Frankel*, *supra* note 205, at 805; FREER & MOLL, *supra* note 117, at 271. *See Wharton v. Fid-Baltimore Nat. Bank,* 222 Md. 177, 183-84 (Md. Ct. App. 1960) ("A director occupies a special status, which has some aspects in common with that of ordinary workers variously called agents, servants and employees, and in some aspects in common with the corporate officers. 'The truth is that the status of director and corporation is a distinct legal relationship. It resembles in some respects those of agent and principal, of managing and dormant partners, of trustee and cestui que trust; but it is different from each.'") *Id*.

[248] *See* note 28. Robert Charles Clark, *Corporate Law*, 114 (1986).

[249] FREER & MOLL, *supra* note 117, at 271; *Priddy v. Edelman*, 883 F.2d 438, 445 (6th Cir. 1989). ("Minority shareholders owe no fiduciary duty to fellow shareholders.") *Id*; *Harris v. Carter*, 582 A. 2d 222, 234 (Del. 1990). ("[A] shareholder has a right to sell his or her stock and in the ordinary case owes no duty in that connection to other shareholders when acting in good faith.") *Id*.

[250] *See Ringling Bros.-Barnum & Bailey Combined Shows v. Ringling*, 29 Del. Ch. 610, 622 (1947). ("Generally speaking, a shareholder may exercise wide liberality of judgment in the matter of voting, and it is not objectionable that his motives may be for personal profit, or determined by whims or caprice, so long as he violates no duty owed his fellow shareholders.") *Id*.

[251] *See* JAMES D. COX & THOMAS LEE HAZEN, BUSINESS ORGANIZATIONS LAW, 271 (4th ed. 2016). ("The basis for the controlling stockholder's fiduciary obligation is the sound policy that, just as directors are bound by certain fiduciary obligations, one who has the potential to control the board's actions should be subject to an obligation as rigorous as those applied to the directors. Quite separate is the belief that control in a corporation, whether publicly or closely held, carries with it the potential that the controlling stockholder may choose to exercise control to reap disproportionate benefits at the expense of the corporation or noncontrolling shareholders such that protection of their interests is desirable. That protection arises by imposing the fiduciary standards on the controlling stockholder exercising the controlling influence.") *Id*; *Kennedy v. Venrock Assocs*., 348 F.3d 584, 589 (7th Cir. 2003). ("[U]nder Delaware law, majority shareholders owe fiduciary duty to the minority shareholders.") *Id*; *Mann v. GTCR Golder Rauner, L.L.C.*, 483 F. Supp. 2d 884, 892 (D. Ariz. 2007). "Delaware law recognizes that not only do directors and officers 'stand in a fiduciary relationship to their corporation and stockholders' but 'a majority shareholder…has a fiduciary duty to the corporation and to its minority shareholders if the majority shareholder dominates the board of directors and controls the corporation.'.") *Id*.; *Gilbert v. El Paso Co*., 490 A.2d 1050, 1055 (Del. 1990). ("Generally, a shareholder who owns less than 50% of a corporation's outstanding stock does not, without more, become a controlling shareholder of that corporation, with a concomitant fiduciary status…For controlling stock ownership to exist in the absence of a numerical majority there must be domination by a minority shareholder through actual exercise of direction over corporate conduct.") *Id*.

The last question to be clarified in this section is: To whom do directors and officers owe fiduciary duty? In general, directors and officers owe fiduciary duty to the corporation and to the shareholders collectively, not individually.[252] This means that directors' and officers' task is to maximize the profit of the corporation itself upon which the shareholders will benefit derivatively.[253] Although the rule says that no fiduciary duty is owed to shareholders individually, when directors and officers seek shareholder action, they act under fiduciary duty.[254] This means that they must act in good faith and fully disclose all material information related to the action.[255]

<u>Summary</u>

Part 1 defines the fiduciary principle and describes when a fiduciary relationship is established. While there is no inclusive definition of who is a fiduciary, a fiduciary has been recognized in several types of relationships including the relationship between corporate insiders and their corporations. Courts have used multiple factors to find that a fiduciary relationship is established including when one person (fiduciary) is entrusted to

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[252] GEVURTZ, *supra* note 47, at 314; FREER & MOLL, *supra* note 117, at 270; *Malone v. Brincat,* 722 A.2d 5, 10 (Del. 1998). ("The directors of Delaware corporations stand in a fiduciary relationship not only to the stockholders but also to the corporations upon whose boards they serve.") *Id*; *International Brotherhood of Electrical Workers Local No. 129 Benfit Fund v. Tucci*, 70 N.E.3d 918, 925–26 (Mass. 2017) "The general rule of Massachusetts corporate law is that a director of a Massachusetts corporation owes a fiduciary duty to the corporation itself, and not its shareholders—although, as indicated in the previous paragraph and as the motion judge recognized, there are at least two exceptions. First, there is a special rule for close corporations…Second, where a controlling shareholder who also is a director proposes and implements a self-interested transaction that is to the detriment of minority shareholders, a direct action by the adversely affected shareholders may proceed."; *Mary E. Bivins Found. v. Highland Capital Mgmt. L.P.,* 451 S.W.3d 104, 111 (Tex. App. 2014) ("Corporate officers owe fiduciary duties to the corporations they serve…but they do not owe fiduciary duties to individual shareholders unless a contract or special relationship exists between them in addition to the corporate relationship.") Some states extend the fiduciary duty to be owed to the shareholders individually. *See* AMENDOLA ET AL., *supra* note 242, at §552.

[253] GEVURTZ, *supra* note 47, at 314.

[254] *Loudon v. Archer-Daniels-Midland Co.,* 700 A.2d 135, 143 (Del. 1987).

[255] AMENDOLA ET AL., *supra* note 242, at §552; CARYL A. YZENBAARD ET EL, THE LAW OF TRUSTS AND TRUSTEES, §481.1., Westlaw (database updated June. 2018); *Id*; *Sims v. Tezak*, 694 N.E.2d 1015, 1018–19 (Ill. App. 1998). ("Delaware courts have addressed the duty of disclosure only with respect to the following five scenarios: mergers, proxy solicitations, tender offers, self-tender offers and stockholder votes.") *Id*.

act and serve the interest of another person (beneficiary) and the fiduciary has superiority or power over the beneficiary because of the trust reposed on him/her to act in good faith to fulfill his/her duty.

Part 1 also defines the fiduciary position of corporate insiders and their general duties and to whom it is owed. Corporate directors, officers, and to some degree large shareholders owe a fiduciary duty to the corporation to solely act to serve the interests of the corporation and to refrain from conduct that is a conflict-of-interest unless informed consent has been given. Corporate insiders are not allowed to unjustly enrich themselves by misusing the property of the corporation including confidential information for their advantage. The fiduciary duty is owed to the corporation not to the shareholders individually.

This understanding of the fiduciary principle and the legal position of corporate insiders help us to examine and discuss the U.S corporate insider trading regulations since the fiduciary position of corporate insiders that allows them to have legitimate access to material non-public information is what makes them a special class of traders regulated by securities laws.

Part 2. Regulations Governing Legal Corporate Insider Trading

Introduction

Section 16 of the SEA[256] is the only statutory section that expressly governs the trading of corporate insiders in their corporations' stock.[257] Section 16 organizes corporate insiders' trades under three rules. First, it requires corporate insiders to disclose securities ownership and trading transactions in their corporation. Second, it prevents them from profiting from speculative trading through the purchase and sale or the sale and purchase of their corporations' stock within six months and making a profit. In addition, Section 16 prohibits corporate insiders from short-selling transactions in their corporations' stock.[258]

Part 2 focuses on examining the structure of Section 16 to regulate the trading activities of corporate insiders. It starts by providing an overview of Section 16 including the legislative history and goals that Congress intended to accomplish by enacting this section. Then it discusses subdivisions (a) reporting requirements and (b) short-swing profit liability of Section 16 and the SEC's rules promulgated thereunder.

Overview of Section 16

When Congress decided to enact regulations for federal stock exchange markets, in 1934, corporate insider trading was one of major issues and problems that Congress addressed in establishing federal securities regulations.[259] One Senate report expressly condemned corporate insiders' unfair use of inside information and described it as a breach of reposed trust and confidence.

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[256] 15 U.S.C.A. §78p. (2012).
[257] Richard W. Painter et al., *Don't Ask, Just Tell: Insider Trading After United States v. O'Hagan*, 84 Va. L. Rev. 153, 161 (1998).
[258] *WANG & STEINBERG, supra* note 5, at 927.
[259] Arnold S. Jacobs, *Section 16 of the Securities Exchange Act*, §1:1, Westlaw (database updated Feb. 2019).

> Among the most vicious practices unearthed at the hearings before the subcommittee was the flagrant betrayal of their fiduciary duties by directors and officers of corporations who used their positions of trust and the confidential information which came to them in such positions, to aid them in their market activities. Closely allied to this type of abuse was the unscrupulous employment of inside information by large stockholders who, while not directors and officers, exercised sufficient control over the destinies of their companies to enable them to acquire and profit by information not available to others.[260]

For the purpose of preventing corporate insiders' unfair use of inside information, Congress enacted Section16.[261] This section now has seven subdivisions. Seciton16(a) requires corporate insiders (directors, officers, and holders of more than 10 percent of a class of equity) to publicly report their beneficial ownership. Section 16(b) prohibits corporate insiders from committing speculation practices, stating that profits made by the purchase and sale or sale and purchase of insiders' corporation stock within six months must be disgorged to the corporation. Section16(c) makes it unlawful for corporate insiders to engage in specific types of speculative trading. This subdivision prohibits corporate insiders from transactions of short sales or selling against the box in their corporations' stock.[262] Section 16(d) provides an exemption from the prohibitions stated under Section16

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[260] S. REP. NO. 73-1455, at 55 (1934).

[261] LOUIS LOSS, SECURITIES REGULATIONS, 1037 (2nd ed. 1961). (Professor Loss found that "[p]rior to the enactment of the Exchange, the SEC has said that 'profits from' 'sure thing' speculation in the stock of their corporations were more or less generally accepted by the financial community as part of the emolument for serving as a corporate officer or director notwithstanding the flagrantly inequitable character of such trading.") *Id*. Citing 10 SEC Ann. Rep. 50 (1944).

[262] For more discussion about §16(c), *see JACOBS*, *supra* note 259, at §4:1. A short sale means a "sale of a security that the seller does not own or has not contracted for at the time of sale and that seller must borrow to make delivery. Such a sale is made when the seller expects the security's price to drop. If the price does drop, the seller can make a profit on the difference between the price of the shares sold and the lower price of the shares bought to pay back the borrowed shares." Black's Law Dictionary (10th ed. 2014). The sale against the box is similar to a short sale and has the same effects on the market. *Jacobs, id.* However, the sale against the box "is less risky than an ordinary short sale." It is a "short sale of a security by a seller who owned enough shares of the security to cover the sale but borrows shares anyway because the seller wants to keep ownership a secret or because the owned shares are not easily accessible." Black's Law Dictionary (10th ed. 2014). The purpose of prohibiting corporate insiders from making short sales and sales against the box is that because insiders have access to inside information, they are not allowed to sell based on bad news that is not known to the public. The goal of making selling against the box is to avoid losses based on the

(b) and Section 16(c). Section16(e) also states that foreign and domestic arbitrage transactions are out of the scoop of Section 16.[263] Section 16(f) and 16(g) include transactions of security future products within this section and designate the SEC as the authority to regulate such transactions.[264]

<u>What Congress Intended to Accomplish by Enacting Section 16</u>

The legislative history shows that Congress determined that making corporate insiders answerable under the SEA for their unfair use of inside information and abuse of their positions as fiduciaries would restore investors' confidence. Congress concluded that:

> A renewal of investors' confidence in the exchange markets can be affected only by a clearer recognition upon the part of the corporate managers of companies whose securities are publicly held of their responsibilities as trustee for their corporation. men charged with the administration of other people's money must not use inside information for their own advantage.[265]

However, instead of articulating broad and general prohibition from misusing inside information, Congress chose to adopt a limited scope of provisions because it realized that there was no effective way to enforce a broad prohibition against abuse of inside information by corporate insiders or their tippees.[266] Congress found that "it is

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expectation of a future decline in the price of the security. The goal of making a short sale is to gain profits from the decrease of the price. *Jacobs*, *id*.

[263] Arbitrage transactions are "the simultaneous buying and selling of identical securities in different markets with the hope of profiting from the price difference between those markets." Black's Law Dictionary (10th ed. 2014). *See Jacobs*, *supra* note 259, at §6:1.

[264] JACOBS, *supra* note 259, at §1:1; THOMAS LEE HAZEN, FEDERAL SECURITIES LAW, 138 (2nd ed. 2003).

[265] SECURITIES EXCHANGE BILL OF 1934, H. R. No. 1383, 73d Cong, 2d Sess. 13 (1934).

[266] *See* Stephen M. Bainbridge, *Incorporating State Law Fiduciary Duties into the Federal Insider Trading Prohibtion*,52 Wash. & Lee L. Rev. 1189, 1234 (1995). ("Congress could have struck at insider trading both more directly and forcibly, and given that congress chose not to do so.") *Id*. In addition, the first draft of §16 prohibited corporate insiders from disclosing inside information to other persons and allowed corporations to recover short-swing profits made by tippees. *Id*; STOCK EXCHANGE REGULATION: HEARING ON H.R. 7852, BEFORE THE COMMITTEE ON INTERSTATE AND FOREIGN COMMERCE, 73D Cong. 2nd Sess. 28-30 (1934). However, the House deleted the prohibition from disclosing inside information and the recovery of short-swing profit made by tippees. The House only kept the requirement of disclosure under §16(a). *See* Michael P. Dooley, *Enforcement of Insider Trading Restrictions*, 66 Va. L. Rev. 1, 58 (1980); H.R. Rep. No. 1383, 24-26.

difficult to draw a clear line as a matter of law between truly inside information and information generally known by the better-informed investors."[267] Therefore, Congress determined that the most effective mechanism to prevent insiders from the unfair use of inside information "was the imposition of a liability based upon an objective measure of proof."[268] The Securities Exchange Bill of 1934 also shows that Congress was aware that the measures adopted under Section 16 were not "air-tight and that the unscrupulous insider may still within the law, use inside information for his own advantage."[269] Nevertheless, they realized that the best weapon against insiders' unfair use of inside information was to require them to make full and prompt disclosure. Congress hoped that the requirement of full disclosure about corporate insiders' trades and securities ownership would help discourage the unfair use of inside information and encourage corporate insiders to maintain "voluntary" fidelity and loyalty by abstaining from abusing the inside information available to them as fiduciaries.[270]

Although Congress stated that the purpose of Section16 was to prevent corporate insiders from abusing inside information, some commentators have described the measures taken by Congress under Section 16 as inadequate to sufficiently prevent insiders from trading on the basis of inside information.[271] Therefore, they suggested that Congress enacted Section 16 to prevent speculative practices by insiders instead of outlawing the abuse of inside information itself.[272] In doing so, using inside information as an

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[267] H.R. Rep. No. 1383, at 13.
[268] *Smolowe v. Delendo Corp.,* 136 F.2d 231, 235 (2d Cir.1943).
[269] H.R. Rep. No. 1383, at 13.
[270] *Id*.
[271] *Dooley*, *supra* note 266, at 56; *Bainbridge*, *supra* note 266, at 1234.
[272] *Id*.

informational advantage was not a concern for Congress in regulating insiders' trades under Section 16.[273] The legislative history of Section 16 shows that Congress was concerned about preventing insiders from speculative practices that were common and accepted among corporate insiders at that time.[274] Professor Michael Dooley argued that the congressional hearings preceding the enactment of SEA focused on preventing corporate insiders from using inside information to manipulate their corporations' stock. During the hearings, he also found that abusing inside information was not an important issue. The witnesses were rarely asked about the use of inside information, and the few questions they were asked were about insiders' manipulative practices.[275]

The legislative history of Section 16 demonstrates that the intention of Congress to enact Section16 was to prevent corporate insiders from misappropriating inside information whether by using such information to manipulate the corporation stock or to trade without public disclosure.[276] Congress intended to prevent corporate insiders from abusing inside information by consolidating the two main purposes of enacting the SEA.

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273 *Loss, supra* note 261, at 1037; *Michael P. Dooley*, at 56, Nt. 255.

274 *Smolowe v. Delendo Corp., 136 F.2d 231, 235 (2d. Cir 1943)* ("We look first to the background of the statute. Prior to the passage of the Securities Exchange Act, speculation by insiders- directors, officers, and principal stockholders- in the securities of their corporation was a widely condemned evil…the insiders' failure to disclose all pertinent information gave them an unfair advantage of the general body of stockholders which was not to be condoned… the Congressional hearings indicate that Sec. 16(b), specifically, was designed to protect the 'outside' stockholders against at least short-swing speculation by insiders with advance information.") *Id*.

275 *Dooley*, *supra* note 266. (Professor Dooley found that "[t]he conventional wisdom is that Congress enacted section 9 to deal with manipulation and expressed its concern with insiders' informational advantage by enacting section 16." "[T]he fact that Congress limited [] [section 16(b)] coverage to profits made form purchase and sales within a six-month period may reflect Congress's concern with insider manipulations. Because most manipulation occur within a short time period, the purposes of section 9 are advanced by denying insiders short-swing profits.") *Id* at 58.

276 Stock Exchange Practices, Hearings on S. Res. 84, 72d Cong, and S. Res. 56 § S. Res. 97, 73d Congress, before the Committee of Banking and Currency, 73d Cong. 6466 (1934) [Hereinafter *Hearings on Stock Exchange Practices*] (testimony of Thomas G. Corcoran) (Section 16 was "designed to protect investors in the market from ignorance and from exploitation by corporate insiders. Lack of information on the part of investors and ignorance of what they are buying..." *Id*.

The legislative history also indicates that enacting the SEA was to restore investors' confidence and to "insure…the maintenance of fair and honest markets."[277] Congress focused on accomplishing these purposes by developing a disclosure system for issuers and other participants in the exchange markets. In addition, it developed provisions to combat manipulative practices. Professor Luis Loss suggested that Congress consolidated "the registration, reporting and proxy provisions of the Exchange Act (§ 12, 13 and 14) …by §16 on insider trading."[278] Thus, by regulating corporate insiders, Section 16(a), required "full and prompt disclosure," as the major mechanism to ensure the maintenance of honest exchange markets on corporate insiders.[279] In addition, Section 16(b), which prohibits corporate insiders from using inside information for speculative practices in their corporations' stock, was adopted to serve another purpose of enacting the SEA, which was to prevent manipulative practices.[280] As Professor Michael Dooley concluded, Section 9 of the SEA prohibits committing manipulative acts, and this section was consolidated with Section 16(b), which prevents corporate insiders from speculative trading in their corporations' stock.[281] Professor Dooley noted that: "the fact that Congress limited [] [section 16(b)] coverage to profits made from purchases and sales within a six-month period may reflect Congress's concern with insider manipulations. Because most manipulations occur within a short time period, the purposes of section 9 are advanced by denying insiders short-swing profits."[282]

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[277] SECURITIES EXCHANGE BILL OF 1934, H. R. No. 1383, 73d Cong, 2d Sess. 10 (1934).
[278] LOSS, *supra* note 261, at 1037.
[279] *See id*.
[280] H.R. Rep. No. 1383, at 10.
[281] *Dooley*, *supra* note 266, at 57.
[282] *Id*.

The imposition of disclosure requirements under Section 16(a), in addition to preventing insiders from trading on the basis of inside information, was imposed to offer up-to-date and accurate trading information for investors.[283] This requirement is meant to help them make informed investment decisions.[284] Investors can use this information to adjust their ask biddings for related securities.[285] In particular, investors may strongly suspect that such disclosed trading was based on inside information, so the timely disclosure enables them to adjust the market price of the security to reflect the new trading information.[286] Even if the insider trades were not based on inside information, public disclosure helps investors receive reliable information about the prospect of the related corporation.[287] For instance, if corporate insiders are buying in their corporations' stock, it may indicate that the market value of the corporation stock is lower than its real value.[288]

The following section examines and discusses subdivisions (a) and (b) of Section 16 since the two subdivisions are the major provisions under Section 16.

Reporting Requirements of Securities Ownership and Trade Transactions

Section 16(a) obligates corporate directors, officers, and beneficial owners of more than 10 percent of a class of any equity security registered pursuant to Section 12 of the SEA,[289] to disclose their beneficial ownership publicly by reporting to the SEC and related

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[283] *See* JACOBS, *supra* note 259, at §2:1.
[284] This concern about investors' lack of information was raised and discussed in the legislative history of §16, where §16 was "designed to protect investors in the market from ignorance and from exploitation by corporate insiders. Lack of information on the part of investors and ignorance of what they are buying..." *Hearings on Stock Exchange Practices*, *supra* note 276, at 6466.
[285] Jesse M. Fried, *Insider Trading Via the Corporation*, 162 U. Pa. L. Rev. 810 (2014); COX ET AL, *supra* note 7, at *944*.
[286] *Fried*, *supra* note 285.
[287] *Id*; *Cox* COX ET AL, *supra* note 7, at *944*.
[288] *Id.*
[289] 15 U.S.C.A. § 78**l**.

exchange.[290] Section 16 corporate insiders are required to report once they become subject to this section by disclosing a list of all aggregated equity securities they beneficially own in the issuer and all transactions in the corporation's security that result in a change in their beneficial ownership.[291] Two main questions arise about duty to disclose in Section 16(a) duty to disclose. The first question is who is statutorily within the status of a corporate insider under Section 16? Second, once corporate insiders are defined and determined, what are they required to disclose under Section 16(a)? These two questions are answered below.

<u>Who is a Section 16 Corporate Insider?</u>

The requirement of disclosure under Section 16(a) was enacted by Congress as it realized that "full and prompt disclosure" is the "best weapon against the abuse of inside information."[292] On this basis of this recognition, Section 16(a)(1) reads:

> (a) Disclosures required.— (1) Directors, officers, and principal stockholders required to file.—Every person who is directly or indirectly the beneficial owner of more than 10 percent of any class of any equity security (other than an exempted security) which is registered pursuant to Section 12, or who is a director or an officer of the issuer of such security, shall file the statements required by this subsection with the Commission.[293]

These corporate insiders are deemed most likely to have access to inside information; therefore, they are regulated as a special class of traders.[294] However, defining who is a 10 percent beneficial owner, director, and officer is subject to complex and

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[290] 15 U.S.C.A. §78p.
[291] *Id*. *See* JACOBS, *supra* note 259, at §2:1.
[292] *See* S. REP. NO. 73-1455, at 55 (1934).
[293] 15 U.S.C.A. §78p.
[294] Lauren Cohen et al, *Decoding Inside Information*, The Journal of Finance, Vol. LXVII, No. 3, 1009 (2012). The SEC states that §16 "was designed to provide the public with information on securities transactions and holdings of corporate insiders and to deter insiders from speculative short-swing trading in their corporations' securities and from engaging in transactions in their corporations' securities while in possession of material, non-public information." SEC. EXCH. COMM'N, RELEASE NO. 17991, OWNERSHIP REPORTS & TRADING BY OFFICERS, DIRECTORS & PRINCIPAL SEC. HOLDERS (Feb. 8, 1991).

detailed statutory provisions and SEC rules.[295] The determination of who is a 10 percent beneficial owner of equity securities, directors, officers of an issuer is discussed below.

Ten Percent Beneficial Owners

Section 16(a) requires 10 percent holders to disclose because it "is intended to reach those persons who can be presumed to have access to inside information because they can influence or control the issuer as a result of their equity ownership."[296] It is noteworthy that the SEC has specified two concepts and two separate definitions of beneficial ownership under Rule 16a-1(a).[297] The first definition is used to determine who is a corporate insider holding more than 10 percent of an equity security of an issuer. The second definition is used to determine the beneficial ownership subject to the duty to report and the liability of short-swing profits after determining that someone is a corporate insider under Section16 whether because such a person is a holder of 10 percent of an issuer's equity security or a director or officer of the issuer.[298] The SEC's Rule 16a-1(a) reads as follows:

> (a) The term beneficial owner shall have the following applications: (1) Solely for purposes of determining whether a person is a beneficial owner of more than ten percent of any class of equity securities registered pursuant to section 12 of the Act, the term "beneficial owner" shall mean any person who is deemed a beneficial owner pursuant to section 13(d) of the Act and the rules thereunder…(2) Other than for purposes of determining whether a person is a beneficial owner of more than ten percent of any class of equity securities registered under Section 12 of the Act, the term beneficial owner shall mean any person who, directly or indirectly, through any contract, arrangement, understanding, relationship or otherwise, has or shares a direct or indirect pecuniary interest in the equity securities.[299]

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[295] However, defining directors and officers is less difficult than defining 10 percent beneficial owners. *See WANG & STEINBERG, supra* note 5, at 928.
[296] SEC. EXCH. COMM'N, RELEASE NO. 17991, at 5.
[297] JACOBS, *supra* note 93, at § 4:13.
[298] *Id*. *See* JACOBS, *supra* note 259, at §2:1.
[299] Rule 16a-1(a), 17 C.F.R. §240. 16a-1(a).

Accordingly, Rule 16a-1(a)(1) imports the definition of beneficial ownership promulgated under Section 13(d) of the SEA to define a beneficial owner of more than 10 percent who will have the status of corporate insider for the purposes of Section 16.[300]

Section 13(d) of the SEA is used to calculate the requisite percentage of equity securities of an issuer, more than 10 percent, upon which a stockholder would be deemed an insider under Section 16.[301] The SEC Rule 13d-3 promulgated under Section 13(d) defines beneficial owners for the purpose of Sections 13(d) and (g) of the SEA to include "any person who, directly or indirectly, through any contract, arrangement, understanding, relationship, or otherwise has or shares… (1) Voting power which includes the power to vote or direct the voting of such security; and/or, (2) Investment power which includes the power to dispose, or to direct the disposition of, such security."[302] The Rule also includes any person who uses a device for the purpose of evading the reporting requirements of Section 13(d) or (g) of the SEA.[303] In addition, a person would be deemed a beneficial owner of a security "if the person has the right to acquire beneficial ownership of such security…within sixty days." including the right to exercise any option, warrant, or right through the conversion of a security, pursuant to the power to revoke a trust, discretionary account, or similar arrangement, or pursuant to the automatic termination of a trust, discretionary account, or similar arrangement.[304]

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[300] 15 U.S.C.A. § 78m. (2012). §13(d) was one of five subsections the Congress added to the SEA of 1934, in 1968. All five provisions were enacted for the purpose of regulating tender offers and changes of control. Section 13(d) requires a person who acquires more than five percent of certain securities to file a statement disclosing the acquisition within ten days to the SEC. *See* James D. Cox & THOMAS LEE HAZEN, TREATIES ON THE LAW OF CORPORATIONS, §24:2. (3d), Westlaw (database updated Nov. 2018); JACOBS, *supra* note 93, at §6:46.

[301] JACOBS, *supra* note 93, at § 4:13.

[302] 17 C.F.R. §240.13d-3.

[303] *Id.*

[304] *Id.*

To determine the requisite number of securities that makes a person a beneficial owner of more than 10 percent of any class of equity securities, Section 13(d) computational rules focus on determining who has actual control over the related securities, whether the person has the right to vote or to dispose of the related securities.[305] The SEC designed the definition of beneficial ownership under Rule 13d-3 to provide objective standards that would allow the courts to have "case-by-case determination."[306] Beneficial ownership is calculated by accumulating the aggregate number of all equity securities[307] of

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[305] Christopher Scott Maravilla, *Reopening the Loophole? Beneficial Ownership under §13(D) of the 1934 Securities Act After Rosenberg v. Xm Ventures*, 3 Charleston L. Rev. 145, 163 (2008). ("[T]he courts determining beneficial ownership under §13(d) of the Act look to who has actual ability to vote the shares or the powers to dispose of a large block of shares."). *Id*. ("In light of the purpose of § 13(d), as evidenced by the legislative history and as interpreted by other courts, the rule states one who possesses the power to dispose of a block of securities is a beneficial owner of any shares of the subject company and a member of a group within the meaning of § 13(d)(3).") *Id*, at 166. JACOBS, *supra* note 259, at §2:67. ("By its literal words, Rule 16a-1(a)(1) merely establishes a test to determine if a person is the "beneficial owner" of a particular security; it does not address how to compute the 10 percent number. Rule 16a-1(a)(1) has been construed to incorporate Section 13(d) computational rules. For instance, a Section 13(d) rule provides that a person beneficial owns securities underlying convertible securities if the convertible securities are convertible within sixty days, but not if they are first convertible thereafter. This applies to Section 16 computations") *Id*. §13(d) tests provide that: (1) "a number of a national securities exchange shall not be deemed to be a beneficial owner of securities held directly or indirectly by it on behalf of another person solely because such member is the record holder of such securities and,… may direct the vote [in certain circumstances]; (2) "A person who in the ordinary course of his business is a pledgee of securities under a written pledge agreement shall not be deemed to be the beneficial owner of such pledged securities until" a default is declared if the (a) the pledge is bona fide; (b) the pledgee is a person eligible to file a schedule 13G; (c) and the pledgee agreement, prior to default, does not grant the pledgee the power to vote or to direct the vote or dispose the pledged securities; (3) "an underwriter of securities who acquires securities through his participation in good faith in a firm commitment underwriting registered under the Securities Act of 1933 shall not be deemed to be the beneficial owner of such securities until the expiration of forty days after the date of such acquisition." Rule 13d-3(b)(2)-(4), 17 C.F.R. §240. 13d-3.

[306] SEC. EXCH. COMM'N, RELEASE NO. 34-64628, BENEFICIAL OWNERSHIP REPORTING REQUIREMENTS AND SECURITIES BASED SWAPS, SECURITIES AND EXCHANGE COMMISSION, File No. S7-10-11, at 7 (effective July 16, 2011).

[307] The SEA, §3(11) defines the term "equity security" as: "any stock or similar security; or any security future on any such security; or any security convertible, with or without consideration, into such a security, or carrying any warrant or right to subscribe to or purchase such a security; or any such warrant or right; or any other security which the Commission shall deem to be of similar nature and consider necessary or appropriate, by such rules and regulations as it may prescribe in the public interest or for the protection of investors, to treat as an equity security." 15 U.S.C.A. § 78c. The SEC defines the term "equity security," for the purpose of §13, under Rule 13d-1(i), which in the pertinent part states that "the term 'equity security' means any equity security of a class which is registered pursuant to section 12 of that Act, or any equity security of any insurance company which would have been required to be so registered except for the exemption contained in section 12(g)(2)(G) of the Act, or any equity security issued by a closed-end

the same class[308] and from all the sources of beneficial ownership, whether alone or with others, and either directly or indirectly.[309] Rule 13d-3(c) states that: "All securities of the same class beneficially owned by a person, regardless of the form which such beneficial ownership takes, shall be aggregated in calculating the number of shares beneficially owned by such person."[310] For instance, convertible voting preferred stock is in the same class as the underlying common stock. In contrast, non-voting convertible preferred stock is considered a class by itself.[311] In addition, Section 13(d)(3) of the SEA asserts that: "When two or more persons act as a partnership, limited partnership, syndicate, or other group for the purpose of acquiring, holding, or disposing of securities of an issuer, such syndicate or group shall be deemed a 'person' for the purposes of this subsection."[312] However, Section 13(d) excludes non-voting securities and derivative securities[313] for the

investment company registered under the Investment Company Act of 1940; *Provided*, Such term shall not include securities of a class of non-voting securities." 17 C.F.R. § 240.13d-1.

[308] §12(g)(5) of the SEA of 1934 defines the term "class" to "include all securities of an issuer which are of substantially similar character and the holders of which enjoy substantially similar rights and privileges." 15 U.S.C.A. § 78l. For more discussion about the definition of the term "class," *see* JACOBS, *supra* note 259, at §2:66.

[309] JACOBS, at §2:67. For the purpose of determining the number of equity securities, Rule 13d-1(j) states that: "any person, in determining the amount of outstanding securities of a class of equity securities, may rely upon information set forth in the issuer's most recent quarterly or annual report, and any current report subsequent thereto, filed with the Commission pursuant to this Act, unless he knows or has reason to believe that the information contained therein is inaccurate." 17 C.F.R. § 240.13d–1.

[310] 17 C.F.R. § 240.13d–3. *See supra* note 305.

[311] JACOBS, *supra* note 2593, at §2:67.

[312] 15 U.S.C.A. § 78m. For more discussion about the group concept under §13(d) and its applicability to §16, *see* JACOBS, *supra* note 93, at 4:13; Peter J. Romeo & Alan L. Dye, *Developments under Section 16*, SR043 ALI-ABA 665 (2010); HAZEN*, supra* note 2, at §11:7. ("One consequence of using the approach under section 16(a) that is applicable to section 13(d) is the concept of a group. Under section 13(d), a group of persons acting together will count as one person for the purpose of computing the ownership threshold. The same group concept applies to section 16(a).") *Id,* at §13:4.

[313] A derivative security is: "A financial instrument whose value depends on or is derived from the performance of a secondary source such as an underlying bond, currency, or commodity." Black's Law Dictionary (10th ed. 2014).

purpose of determining beneficial owners under Section 13(d) except securities that are convertible or exercisable within sixty days.[314]

Although Rule 16a-1(a) has incorporated Section13(d) rules to define the term "beneficial owner" for the purpose of determining whether a person is a beneficial owner of more than 10 percent of equity securities under Section 16, the SEC departed slightly from Section 13(d) of the SEA, and the rules promulgated thereunder. They waived the reporting requirement under Section 16, from certain institutions and persons even though they hold beneficial ownership of more than 10 percent of an issuer's equity securities where the holding of ownership is for the benefit of another person and not for the purpose of directing the control of the issuer.[315]

Directors

The rules promulgated under Section 16 do not provide a special definition of corporate directors for the purpose of the requirement of filing reports under Section 16(a) and prohibition of short-swing profits under Section 16(b).[316] The SEC simply imported the statutory definition of directors stated under Section 3(a)(7) of the SEA.[317] This section

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[314] *See* SEC. EXCH. COMM'N, RELEASE NO. 17991, OWNERSHIP REPORTS & TRADING BY OFFICERS, DIRECTORS & PRINCIPAL SEC. HOLDERS, at 5 (Feb. 8, 1991). ("The Section 13(d) analysis, such as the exclusion of non-voting securities and counting only those derivative securities exercisable or convertible within 60 days, are imported into the ten percent holder determination for Section 16 purposes.") *Id*. *See* HAZEN*, supra* note 2, at §13:4.

[315]*Romeo*, *supra* note 312, at 677. For more information about the calculation of 10 percent ownership and exceptions under §13(d), *see* Rule 16a-1(a)(1)(i) through (xi), 17 C.F.R. §240. 16a-1. *See* JACOBS, *supra* note 93, at §4:13.

[316] *See WANG & STEINBERG, supra* note 5, at 972.

[317] The SEC clarified that: "No definition for the term "director" is proposed because there appears to be little confusion about the definition of that term in section 3(a)(7) of the Exchange Act." SEC. EXCH. COMM'N, RELEASE NO. 17991, at 8. *See Id*; JACOBS, *supra* note 259, at §2:68.

defines directors as: "any director of a corporation or any person performing similar functions with respect to an organization, whether incorporated or unincorporated."[318]

The phrase "or any person performing similar functions…" indicates that others who perform functions that are similar to directors but have not been hired or elected to serve as directors are deemed directors under the SEA including Section 16.[319] The courts use an objective standard to determine whether a person is a director which allows the courts to apply the term "director" to other persons who perform similar functions but are not officially serving as directors.[320] The most important factor to determine whether a person is a director under Section 16 is whether the person has access to inside information and the nature of his/her responsibilities and duties within the corporation.[321]

One of the most important issues related to the question of determining who is a director for the purpose of Section 16 is whether an entity can be regarded as a director of an issuer under Section 16 because the entity has a representative or deputy of the entity serves as a director of the issuer.[322] However, the SEC has decided not to codify the

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[318] SEA, §3(a)(7), 15 U.S.C.A. §78c(a)(7). The term "person" used in the definition of the term "director" is also defined under §3(a)(9) of the SEA. "The term 'person' means a natural person, company government, or political subdivision, agency, or instrumentality of a government." *Id*. at §3(a)(9), §78c(a)(9).
[319] JACOBS, *supra* note 259, at §2:68. Citing *Reliance Elec Co. v. Emerson Elec. Co.,* 404 U.S. 418, 424 Nt. 4, (1927). "[I]n deciding whether an investor is an 'officer' or 'director' within the meaning of s 16(b), courts have allowed proof that the investor performed the functions of an officer or director even though not formally denominated as such." *Id*.
[320] *Id*.
[321] *Gold v. Sloan*, 486 F. 2d, 340, 342 (4th Cir. 1993). ("The purpose of the statute was to take 'the profits out of a class of transactions in which the possibility of abuse was believed to be intolerably great' and to prevent the use by 'insiders' of confidential information, accessible because of one's corporate position or status, in speculative trading in the securities of one's corporation for personal profit.") *Id*. *See J* JACOBS, *supra* note 259, at §2:68. *See* Ownership Reports and Trading by Officers, Directors and Principal Stockholders, *supra* note 63, at 9; SEC. EXCH. COMM'N, RELEASE NO. 17991, *at 4.* ("in determining whether an advisory, emeritus or honorary director is a director for Section 16 purposes, the person's title is not determinative."). *Id*.
[322] MARC I. STEINBERG, SECURITIES REGULATIONS: LIABILITIES AND REMEDIES, §4.03 (Lexis).

deputization doctrine and left the doctrine to be determined by the courts. The SEC found that:

> [A] corporation, partnership, trust or other person can be deemed a director for purposes of section 16 where it has expressly or impliedly "deputized" an individual to serve as its representative on a company's board of directors. In determining whether a person has been deputized for purposes of section 16, the courts have looked at a variety of factors, focusing primarily on the alleged deputy's position of control within the deputizing entity and the deputy's independent qualifications to serve on the board of the issuing corporation. This fact-intensive analysis appears best left to a case-by-case determination."[323]

Although the courts have recognized the deputization doctrine and held that an entity may be found in the position of a director of an issuer under Section 16 by deputizing one of its members or employees to represent the entity in the issuer's board of directors,[324] the rules that determine the presence of deputization are not "bright-line" once.[325] Thus, the determination of whether a deputization exists is a question of fact and determined case-by-case.[326]

<u>Officers</u>

The regulatory definition of officers under Section 16 follows the same path as defining directors, where officers who have policy making roles inside the issuer are subject to Section 16.[327] Rule 16a-1(f) reads as:

> The term "officer" shall mean an issuer's president, principal financial officer, principal accounting officer (or, if there is no such accounting officer, the controller), any vice-president of the issuer in charge of a principal business unit, division or function (such as

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323 SEC. EXCH. COMM'N, RELEASE NO. 24768, OWNERSHIP REPORTS AND TRADING BY OFFICERS, DIRECTORS AND PRINCIPAL STOCKHOLDERS, at 8 (Dec. 2, 1988) *see* JACOBS, *supra* note 259, at §2:68; THOMAS LEE, HAZEN, *THE LAW OF SECURITIES REGULATION*, 564 (7th ed. 2017).
324 *See* note 88,
325 STEINBERG, at §4.03. ("The factors that are necessary for a finding of deputization, however, are somewhat ambiguous due to the *ad hoc* approach employed by the courts.") *Id*.
326 *Hazen*, *supra* note 323, at 565.
327 *See WANG & STEINBERG, supra* note 5, at 976; HAZEN*, supra* note 2, at §13:3.

sales, administration or finance), any other officer who performs a policy-making function, or any other person who performs similar policy-making functions for the issuer.[328]

Rule 16a-1(f) defines the term "officer" narrowly to exclude others who have the title of officer but preform no substantial policy functions.[329] The SEC has clarified the Rule 16a-1(f) approach stating that the definition of the term "officer" must be applied to "[t]hose exercising a policy-making function, by the very nature of that responsibility, have routine access to material non-public information."[330] The SEC also asserted that "the proper focus should be on whether a person is a corporate employee performing important executive duties of such character that he would be likely, in discharging these duties, to obtain confidential information about the company's affairs that would aid him if he engaged in personal market transactions."[331] Therefore, the Rule includes specific titled officers under the definition of "officer" since they are most likely to perform a policy-making function and have access to inside information. Those officers are the president of the issuer, principal financial officer, principal accounting officer (or the controller if there is no principal accounting officer), or any vice president who is also in charge of a principal business unit. In addition to these named officers, under the definition of "officer," the Rule includes any person who performs the function of an officer but does not have the title of an officer.[332] The Rule excludes persons who have the title of "officer" but do not perform significant policy-making functions within the corporation. In particular, it excludes

[328] Rule 16a-1(f), 17 C.F.R. §240.16a-1(f).
[329] STEINBERG*, supra* note 322, at §4.04 4-53.
[330] SEC. EXCH. COMM'N, RELEASE NO. 24768, OWNERSHIP REPORTS AND TRADING BY OFFICERS, DIRECTORS AND PRINCIPAL STOCKHOLDERS, at 8 (Dec. 2, 1988).
[331] *Id*. at 4.
[332] *Hazen*, *supra* note 323, at 564; SEC. EXCH. COMM'N, RELEASE NO. 17991, at 4. ("A person's title alone should not determine whether that person is subject to Section 16… If title were determinative, persons with executive functions could avoid responsibility by forgoing title.") *Id*.

persons who hold the position of vice president but are not in charge of a principal business unit or do not perform policy-making functions.[333]

Definition of Beneficial owners—Pecuniary Interest

When a person is determined to be a beneficial owner of more than 10 percent of any class of issuer's equity securities or a director or officer of an issuer, the person becomes subject to Section 16. To determine what securities are subject to Section 16(a) reporting requirements as well as Section 16(b), corporate insiders are subject to the definition of "beneficial owners."[334] Rule 16a-1(a)(2) defines a beneficial owner as: "any person who, directly or indirectly, through any contract, arrangement, understanding, relationship or otherwise, has or shares a direct or indirect pecuniary interest in the equity securities."[335] The term "pecuniary interest" means "the opportunity, directly or indirectly, to profit or share in any profit derived from a transaction in the subject securities."[336]

Rule 16a-1(a)(2)(ii) provides six examples of an indirect pecuniary interest. It includes securities held by immediate family members, and a partnership's portfolio securities if the beneficial owner is a general partner in such partnership.[337] It also includes

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[333] Rule 16a-1(f) "Policy-making function" is not intended to include policy-making functions that are not significant." *Id*, 17 C.F.R. § 240.16a-1(f). *See* Ownership Reports and Trading by Officers, Directors and Principal Stockholders, *supra* note 63, at 8; STEINBERG*, supra* note 322, at §4.04 4-53; JACOBS, *supra* note 259, at §2:69.
[334] *Id*, at 930; JACOBS, *supra* note 93, at §4:14; SEC. EXCH. COMM'N, RELEASE NO. 17991.
[335] Rule 16a-1(a)(2), 17 C.F.R. § 240.16a-1(a)(2).
[336] Rule 16a-1(a)(2)(i), 17 C.F.R. § 240.16a-1(a)(2)(i).
[337] Rule 16a-1(a)(2)(ii), 17 C.F.R. §240. 16a-1(a)(2)(ii). (This rule, in the pertinent part, states that (ii) The term indirect pecuniary interest in any class of equity securities shall include, but not be limited to: (A) securities held by members of a person's immediate family sharing the same household; provided, however, that the presumption of such beneficial ownership may be rebutted. *see* also § 240.16a–1(a)(4) and (B) a general partner's proportionate interest in the portfolio securities held by a general or limited partnership.") The general partner's pecuniary interest attribution is "in proportion to the greater of their capital account or interest in the profit of the partnership at the time of the transaction." SEC. EXCH. COMM'N, RELEASE NO. 17991, OWNERSHIP REPORTS & TRADING BY OFFICERS, DIRECTORS & PRINCIPAL SEC. HOLDERS, at 6 (Feb. 8, 1991). Rule 16a-1(e) states that "The term immediate family shall mean any child, stepchild, grandchild, parent, stepparent, grandparent, spouse, sibling, mother-in-law, father-in-law, son-in-law, daughter-in-law,

performance-based fees "received by any broker, dealer, bank, insurance company, investment company, investment adviser, investment manager, trustee or person or entity performing a similar function,"[338] and in the event that a "person's right to dividends that is separated or separable from the underlying securities."[339] The fifth example of an indirect pecuniary interest is the person's interest held by a trust with certain details stated in Rule 16a-8.[340] The last example is the right to "acquire equity security through the exercise or conversion of any derivative security, whether or not presently exercisable."[341]

This definition of beneficial owners is not exclusive for the purpose of determining what securities beneficial owners of more than 10 percent must disclose, but rather the definition is applied to all Section 16 corporate insiders including directors and officers.[342] The determination focuses primarily on whether profits made from trading on securities

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brother-in-law, or sister-in-law, and shall include adoptive relationships." *Id*, 17 C.F.R. § 240.16a-1(e). *See* HAZEN*, supra* note 2, at §13:4. ("The determination of beneficial ownership, as between an insider and spouse frequently presents difficult factual questions. For example, within the context of a 16(b) action to recover proscribed short-swing profits, it has been held that a wife's sale of securities is attributed to her husband who is a director of the issuer even where the husband and wife maintain separate brokerage accounts but engaged in some joint planning…the current section 16 rules codify this result.") *Id*.

[338] Rule 16a-1(a)(2)(ii)(c), 17 C.F.R. § 240.16a-1(a)(2)(ii)(C).

[339] Rule 16a-1(a)(2)(ii)(c), 17 C.F.R. § 240.16a-1(a)(2)(ii)(D).

[340] Rule 16a-1(a)(2)(ii)(E), 17 C.F.R. § 240.16a-1(a)(2)(ii)(E).

[341] Rule 16a-1(a)(2)(ii)(F), 17 C.F.R. § 240.16a-1(a)(2)(ii)(F). The term "derivative securities" has certain exemptions under Rule 16a-1. Paragraph (c) of Rule 16a-1 states that: "(c) The term derivative securities shall mean any option, warrant, convertible security, stock appreciation right, or similar right with an exercise or conversion privilege at a price related to an equity security, or similar securities with a value derived from the value of an equity security." Rule 16a-1(c), 17 C.F.R. § 240.16a-1(c). However, Rule 16a-1(c) provides 7 exemptions from the definition of derivative securities, as follows: (1) Rights of a pledgee of securities to sell the pledged securities; (2) Rights of all holders of a class of securities of an issuer to receive securities pro rata, or obligations to dispose of securities, as a result of a merger, exchange offer, or consolidation involving the issuer of the securities; (3) Rights or obligations to surrender a security, or have a security withheld, upon the receipt or exercise of a derivative security or the receipt or vesting of equity securities, in order to satisfy the exercise price or the tax withholding consequences of receipt, exercise or vesting; (4) Interests in broad-based index options, broad-based index futures, and broad-based publicly traded market baskets of stocks approved for trading by the appropriate federal governmental authority; (5) Interests or rights to participate in employee benefit plans of the issuer; (6) Rights with an exercise or conversion privilege at a price that is not fixed; or (7) Options granted to an underwriter in a registered public offering for the purpose of satisfying over-allotments in such offering." *Id*.

[342] *See* SEC. EXCH. COMM'N, RELEASE NO. 17112, OWNERSHIP REPORTS & TRADING BY OFFICERS, DIRECTORS & PRINCIPAL SEC. HOLDERS, at 8 (Aug. 18, 1989).

would increase the beneficial owner's wealth.[343] Thus, the definition of beneficial owners and the pecuniary interest tests include a wide range of scenarios of having or sharing profits from securities trading. Professor Arnold S. Jacobs suggested that there are four situations when a beneficial owner under Section 16 will be deemed to have or share a pecuniary interest for the purpose of the definition of beneficial owners stated in Rule 16a-1(a)(2):

1- A corporate insider directly having or sharing a pecuniary interest, e.g., the beneficial owner owns the securities;

2- A corporate insider directly having or sharing an indirect pecuniary interest, e.g., the spouse of the corporate insider owns the securities, or the beneficial owner is a general partner in a partnership that owns the securities;

3- A corporate insider indirectly having or sharing direct pecuniary interest, e.g., when the beneficial owner has "a contract with natural person who owns the securities."

4- A corporate insider indirectly having or sharing indirect pecuniary interest, e.g., the beneficial owner is not a partner and has a contract with the partnership that possesses the securities.[344]

It is important to mention that the pecuniary interest can only be derived from trading activities whether such trading is in the form of purchase or sale of related securities. This means that the profit or interest that results from non-trading transactions does not constitute a pecuniary interest, such as the opportunity to profit from or share the

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343 *LANGEVOORT*, *supra* note 6, at §10:4.
344 JACOBS, *supra* note 93, at §4:15.

profit from dividends.[345] This observation is emphasized by Rule 16a-1(a)(2)(ii)(D) which states that: "a right to dividends alone shall not represent a pecuniary interest in the securities."[346]

Rule 16a-1 also grants certain exemptions from deeming some securities transactions or the opportunity to profit from having a pecuniary interest. Corporations or similar entities that are held in portfolio securities are not attributed to the corporations' shareholders as having a pecuniary interest in such portfolio securities under two conditions: (1) the shareholder is not a "controlling shareholder" of the corporation or similar entity; and (2) does not have investment control, either alone or with other, over the portfolio securities.[347] Rule 16a-1(a)(5) also states that certain pecuniary interest is not recognized as a part of the definition of beneficial ownership under Section 16. These exempted interests are "[i]nterests in portfolio securities held by any investment company registered under the Investment Company Act of 1940;[348] and (ii) Interests in securities comprising part of a broad-based, publicly traded market basket or index of stocks, approved for trading by the appropriate federal governmental authority."[349]

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[345] *Id*. The SEC explained that: "Indirect pecuniary interest represents the insider's ability to profit from purchases and sales in securities held by family members, or through derivative securities, partnerships, corporations, trusts and 'other arrangements.' An indirect pecuniary interest arising from "other arrangements" would include, among other things, any formal or informal agreement to share profits from transactions in a particular issuer's securities. For example, this would include parking arrangements and specified interests in fee arrangements." SEC. EXCH. COMM'N, RELEASE NO. 17112, at 8.

[346] Rule 16a-1(a)(2)(ii)(D), 17 C.F.R. § 240.16a-1(a)(2)(ii)(D).

[347] Rule 16a-1(a)(2)(iii), 17 C.F.R. § 240.16a-1(a)(2)(iii).

[348] 15 U.S.C. 80a–1 et seq.

[349] Rule 16a-1(a)(5)(i) and (ii), 17 C.F.R. § 240.16a-1(a)(5)(i) and (ii). *See* JACOBS, *supra* note 259, at §4:15.

Times and Forms of Section 16(a) Filing Reports

Section 16 of the SEA requires directors and officers of an issuer in addition to beneficial owners of more than 10 percent of any class of equity security to file certain statements with the SEC at certain times.[350] Section 16(a)(2) reads:

> (2) Time of filing The statements required by this subsection shall be filed-- (A) at the time of the registration of such security on a national securities exchange or by the effective date of a registration statement filed pursuant to section 12(g) (B) within 10 days after he or she becomes such beneficial owner, director, or officer, or within such shorter time as the Commission may establish by rule (C) if there has been a change in such ownership, or if such person shall have purchased or sold a security-based swap agreement involving such equity security, before the end of the second business day following the day on which the subject transaction has been executed, or at such other time as the Commission shall establish, by rule, in any case in which the Commission determines that such 2-day period is not feasible.[351]

The SEC used its authority under Section 16 and issued Rule 16a-3 for the purpose of implementing the requirement of disclosure under Section 16(a).[352] Rule 16a-3 imposes three filing forms, Forms 3, 4, and 5.[353] Form 3 is the initial report that is required when a person occupies the status of corporate insider under Section 16. Filing Form 3 is due on the same day as the effective date of the registration of securities pursuant to Section 12(g) of the SEA.[354] In the absence of the event of the registration for securities with the SEC, Form 3 is due within 10 days when a person becomes a corporate insider of an issuer in

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[350] *See WANG & STEINBERG, supra* note 5, at 929; *Galanti*, *id*.
[351] §16(a)(2), 15 U.S.C.A. § 78p(a)(2).
[352] Rule 16a-3(a), 17 C.F.R § 240.16a-3(a).
[353] SEC. EXCH. COMM'N, RELEASE NO. 34-46421, OWNERSHIP REPORTS AND TRADING BY OFFICERS, DIRECTORS AND PRINCIPAL SECURITY HOLDERS (August 27, 2002), https://www.sec.gov/rules/final/34-46421.htm.
[354] §12(g) of the SEA requires issuers who have, at the end of their fiscal year, total assets of more than $10 million and a class of equity security held of record by either: (1) 2000 person; or (2) 500 persons who are not accredited investors. The filings of the registration must be done within 120 days of the end of the fiscal year that triggers §12(g) registration requirement. §12(g)(a) of the Exchange Act of 1934, 15 U.S.C.A. § 78*l*. *See* HAZEN, *supra* note 2, at §9:3.

accordance to Section 16.[355] Through Form 3, a corporate insider must disclose his/her beneficial ownership of equity securities of the issuer as required under rule 16a-1(a)(2).[356]

Form 4 is filed with the SEC when there is a change regarding the beneficial ownership of the corporate insider of the issuer. Filing Form 4 is required by the end of the second business day following the execution of a transaction that results in a change.[357] Disclosure of the occurrence of a change in beneficial ownership by filing Form 4 covers most transactions including securities transactions between officers or directors and the issuer.[358] This includes transactions such as issuances, cancellations, registrants, and re-pricing of stock options.[359] Section 16 corporate insiders are exempted from filing Form 4 for certain transactions including a change in beneficial ownership or an increase or decrease in the number of held securities as a result of a stock split or stock dividends applying equally to all holders of a class of equity security.[360] It also includes all pro rata granting of rights to all holders of the same class of equity security,[361] and small acquisitions of the issuer's equity security or the right to acquire the security if the security does not exceed $10,000 in market value.[362]

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355 §16(a)(2)(A)(B); Rule 16a-3(a), 17 C.F.R § 240.16a-3(a).
356 *Id*.
357 §16(a)(2)(C), 15 U.S.C.A. § 78p(a)(2)(C). Pursuant to Rule 16a-3(g), there are two exemptions from the two business days requirement to disclose securities transactions that result in a change of beneficial ownership. The two exemptions involve transactions that a §16 corporate insider has no control over: (1) Rule 10b5-1 trading plans if the insider does not select the dates of trades, Rule 16a-3(g)(1), 17 C.F.R § 240.16a-3(g)(1); and (2) discretionary transactions involving employee benefit plans when the insider also does not assign the dates of trades, Rule 16a-3(g)(3), 17 C.F.R § 240.16a-3(g)(3). The time of the execution of the transaction is deemed at the date when such insider is notified about the execution of the transaction. Then, the filing of Form 4 must be submitted by the end of the second business day following the date of the notification. Rule 16a-3(g)(2)(3), 17 C.F.R § 240.16a-3(g)(2)(3).
358 HAZEN, *supra* note 2, at §13:2.
359 *Id*.
360 Rule 16a-9(a), 17 C.F.R. §240.16a-9(a)
361 Rule 16a-9(b), 17 C.F.R. §240.16a-9(b); *See* HAZEN, *supra* note 2, at §13:7.
362 Rule 16a-6(a), 17 C.F.R. §240.16a-6(a). Other exemptions include (1) transactions that only change the form of beneficial ownership, Rule 16a-13, 17 C.F.R. §240.16a-13; (2) Acquisitions or dispositions of

Form 5 is the third form that must be filed with the SEC.[363] Section 16 corporate insiders must file Form 5 within 45 days after the end of the issuer's fiscal year.[364] Form 5 is used to report transactions that were not reported in Forms 3 and 4 either because these transactions were exempted or they were not exempted but the corporate insider did not disclose them in Forms 3 or 4. Form 5 must disclose all transactions in the last fiscal year, including exempted transactions from §16(a) and (b).[365] Forms 3, 4, and 5 must be filed with the SEC electronically through EDGAR. If the issuer has a website, it is required to make the information in the forms available on the official website the day after filing with the SEC.[366]

<u>Section 16(b) Short-Swing Profit Liability</u>

Section 16(b) of the SEA is a statutory provision that expressly prohibits Section 16 corporate insiders from using inside information for trading activities.[367] This Section allows the issuer to recover profits made by the insider from speculative trading transactions that occur within six months, called "short-swing" profits. Congress determined that allowing issuers to recover these profits is the most visible and effective

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securities pursuant to a domestic relations order meeting certain condition codes, Rule 16a-12, 17 C.F.R. §240.16a-12; (3) Exempt transactions pursuant to tax-conditioned plans, Rule 16a-3(f)(1)(i)(B), 17 C.F.R. §240.16a-3(f)(1)(i)(B), and Rule 16b-3(c), 17 C.F.R. §240.16b-3(c); (4) The disposition or closing of long derivative securities as a result of cancellation or expirations, Rule 16a-4(b), 17 C.F.R. §240.16a-4(b); (5) Transactions by former officers or directors after six months of an opposite transaction subject to §16(b) or the transaction is exempted from the scope of §16(b), Rule 16a-2(b), 17 C.F.R. §240.16a-2(b). *See WANG & STEINBERG, supra* note 5, at 933.For more discussion about the exempted transactions from filing in Form 4, *see* HAZEN, *supra* note 2, at §13:7.

[363] Rule 16a-3(f), 17 C.F.R. §240.16a-93(f).

[364] *Id.*

[365] Rule 16a-3(f)(1).

[366] §16(a)(4), 15 U.S.C.A. § 78p(a)(4). *See* SEC. EXCH. COMM'N, RELEASE NO. 817, IN RE MANDATED ELEC. FILING & WEBSITE POSTING FOR FORMS 3, 4 & 5 (Dec. 20, 2002). For more discussion about §16(a) filing forms, *see Hazen*, *supra* note 88, at 564; *WANG & STEINBERG, supra* note 5, at 928; HAZEN*, supra* note 2, at §13:2; JACOBS, *supra* note 259, at §2:71.

[367] *LANGEVOORT*, *supra* note 6, at §10:1.

weapon against insiders' unfair use of inside information.[368] However, only private enforcement of this section is available, and it depends on the issuer's willingness to seek payment of such ill-gotten profit. If the issuer is not willing to enforce Section 16(b) short-swing profit liability, a shareholder, through a derivative suit, could judicially bring such a claim.[369] Section 16(b) of the SEA reads:

> For the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer, any profit realized by him from any purchase and sale, or any sale and purchase, of any equity security of such issuer (other than an exempted security) or a security-based swap agreement involving any such equity security within any period of less than six months…shall inure to and be recoverable by the issuer, irrespective of any intention on the part of such beneficial owner, director, or officer in entering into such transaction of holding the security or security-based swap agreement purchased or of not repurchasing the security or security-based swap agreement sold for a period exceeding six months.[370]

Section 16(b) prohibits the unfair use of inside information by Section 16 corporate insiders through designing straightforward liability from the gain of short-swing profits that have resulted from speculative trades. Short-swing profit is defined as "profit made by a corporate insider on the purchase and sale (or sale and purchase) of company stock within a six-month period."[371] This section can also be considered a prophylactic rule designed to find liability for misusing inside information based on an objective standard upon which there is no need to question the intent of the corporate insider or his/her possession of inside information at the time of the trades in question.[372] It is important to mention that the liability of short-swing profits under Section 16(b) was designed to prevent Section 16

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[368] SECURITIES EXCHANGE BILL OF 1934, H. R. No. 1383, 73d Cong, 2d Sess. 13 (1934). *See Id*.
[369] *Id*; *WANG & STEINBERG, supra* note 5, at 924.
[370] Section 16(b) of the Exchange Act of 1934, 15 U.S.C.A. § 78p.
[371] Short-swing profits, Black's Law Dictionary (10th ed. 2014).
[372] *LANGEVOORT, supra* note *6, at* § 10:1; *WANG & STEINBERG, supra* note 5, at 924; *Hazen*, *supra* note 88, at 556.

corporate insiders from unfair use of inside information, but it was not meant to provide a compensatory remedy for the issuer.[373]

Section 16(b) contains two important points that are under the scrutiny of the courts and the SEC: the determination of when a purchase and sale occur, and the exempted transactions from short-swing liability. These two issues are discussed below.

Purchase or Sale

Although Section 16(b) was designed to be straightforward liability to prevent insiders from unfair use of inside information, the rapid development of business transactions and financial instruments have led to a highly complex era where the determination of whether a transaction is a purchase or sale may become obscure.[374] Section 3(a)(13) of the SEA defines the terms "buy" and "purchase" as: "any contract to buy, purchase, or otherwise acquire."[375] In addition, Section 3(a)(14) of the SEA defines the terms "sale" and "sell" to mean "any contract to sell or otherwise dispose of."[376]

To find a Section 16 corporate insider liable under Section 16(b), the insider must purchase and sell (or sell and purchase) the issuer's securities within a six-month period. A purchase of securities can occur in straightforward transactions in the form of cash-for-stock transactions. It can also occur in the form of "unorthodox" transactions, such as the conversion of debt securities or exercising of options "or the exchange of one security for another" security.[377] In addition, Section 16(b) does not require that the purchase and sale

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[373] *Hazen*, *supra* note 88, at 556.
[374] JACOBS, *supra* note 93, at §4:155.
[375] Section 3(a)(13) of the Exchange Act of 1934, 15 U.S.C.A. § 78c(a)(13).
[376] Section 3(a)(14) of the Exchange Act of 1934, 15 U.S.C.A. § 78c(a)(14). *See* JACOBS, *supra* note 93, at §4:155. (Finding that "the terms 'purchase' and 'sale' reach many transactions not ordinarily deemed to be a purchase or a sale, and go well beyond the contracts to buy or to sell referenced in the statutory definitions.") *See also WANG & STEINBERG, supra* note 5, at 994.
[377] HAZEN, *supra* note 264, at 143.

be through the same type of security, but it covers exercisable and converted securities. For instance, "the purchase of a convertible debenture can be matched with the sale of common stock" whether or not a conversion occurs.[378] The finding of purchase transactions can also be found when a Section 16 corporate insider acquires a derivative security, such as a call option; thus, this acquisition of the derivative security can be matched against the sale or the disposition of the same derivative security or the underlying securities if the two transactions occur within a six-month period.[379]

Two judicial tests have evolved to establish whether a transaction is a "purchase" or "sale" under Section 16(b): the "objective" test and the "pragmatic" test.[380] The objective test is defined as "a transfer that constitutes a purchase or a sale is in fact a statutory purchase or sale, regardless of the voluntary or involuntary nature of the exchange and whether or not the insider has access to inside information."[381] In early Section 16(b) cases, courts tended to construe the language of this section to maintain strict liability standards that were general and would be applied to any transactions that could be construed to be within the statutory meaning of the "purchase and "sale."[382] The Second Circuit in *Smolowe v. Delendo Corp.*,[383] stated that "the language of Sec. 16(b) [] as well as from the Congressional hearings, [indicate] that the only remedy which its framers deemed effective for this reform was the imposition of a liability based on an objective measure of proof."[384]

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378 COX ET AL, *supra* note 7, at 950.
379 *Hazen*, *supra* note 88, at 569. ("However, the exercise of the option at a fixed exercise price is neither a sale nor purchase for Section 16 purposes." Citing 17 C.F.R. §240.16b-6.)
380 *Id*.
381 JACOBS, *supra* note 93, at §4:155.
382 *WANG & STEINBERG, supra* note 5, at 995.
383 *136 F.2d 231 (1943)*
384 *Id*. at 235.

The pragmatic test is applied to transactions that are in doubt under the statutory definition of "purchase" and "sale."[385] This type of doubtful transactions is called "unorthodox" transactions. However, the pragmatic test applied to unorthodox transactions is unclear and ill-defined.[386] The pragmatic test applied to unorthodox transactions can be defined as:

> [A]transfer that constitutes a purchase or a sale is in fact a statutory purchase or sale unless, as to the subject insider, (1) the transfer was involuntary, in the sense that the insider had an utter inability to control the transaction, and (2) the insider neither had nor was likely to have had access to material inside information by virtue of his insider status.[387]

The leading case that approved the pragmatic test was the U.S. Supreme Court's decision in *Kern County Land Co., v. Occidental Petroleum Corp*.[388] The court analyzed the types of trading transactions and realized that traditional cash-for-stock transactions that result in a purchase and sale (or sale and purchase) within six months, are clearly within the purview of Section 16(b). However, the Supreme Court noted that the statutory

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[385] *LANGEVOORT*, *supra* note 6, at §10:11.

[386] *See* JACOBS, *supra* note 93, at §4:155.; *WANG & STEINBERG, supra* note 5, at 997, citing Tomlinson, Section 16: A Single Analysis of Purchase and Sales—Merging the Objective and Pragmatic Analysis, 1981 Duke L.J. 941, 947(footnotes omitted).

[387] JACOBS, *supra* note 93, at §4:155. *See* also

[388] 411 U.S. 582 (1973). The case involved Occidental Petroleum Corps (Occidental) who unsuccessfully attempted to acquire Kern County Land Co. (Old Kern) by a tender offer that resulted in acquiring more than 10 percent of the outstanding shares of Old Kern. While Occidental extended its tender offer to buy additional shares of Old Kern, the management of Old Kern defeated the hostile takeover by agreeing to merge with Tenneco, Inc. (Tenneco) in which the shareholders of Old Kern would receive in exchange for each share, a share of Tenneco cumulative convertible preference stock. The merger formed a new company (New Kern) a wholly owned subsidiary of Tenneco Corp. Because Occidental involuntary "would have to exchange its old shares for Tenneco stock and would be locked into monitory position in Tenneco," Occidental negotiated "an arraignment with Tenneco a share of Tenneco cumulative convertible preference stock… By the terms of the option agreement, the option could not be exercised prior to…[A] date six months and one day after expiration of Occidental's tender offer." The option was exercised after that date and was designed to be the date of exercising the option. The New Kern filed a suit under §16(b) "against Occidental to recover the profits which Occidental had realized as a result of its dealings in Old Kern stock." The allegation was based on the fact that the execution of the Occidental-Tenneco option, and the exchange of Old Kern shares for shares of Tenneco pursuant to the merger were both sales within the meaning of §16(b) because both of these events took place within six months of the date on which Occidental became a holder of more than 10 percent of Old Kern stock. *Id*. at 584-590.

definitions of purchase and sale "reach many transactions not ordinarily deemed a sale or purchase,"[389] and they found that "the courts have wrestled with the question of inclusion or exclusion of certain 'unorthodox' transactions."[390] Therefore, the Supreme Court ruled that:

> In deciding whether borderline transactions are within the reach of the statute, the courts have come to inquire whether the transaction may serve as a vehicle for the evil which Congress sought to prevent—the realization of short-swing profits based upon access to inside information—thereby endeavoring to implement congressional objectives without extending the reach of the statute beyond its intended limits… [T]he prevailing view is to apply the statute only when its application would serve its goals. '(W)here alternative constructions of the terms of s 16(b) are possible,...'[I]n interpreting the terms 'purchase' and 'sale,' courts have properly asked whether the particular type of transaction involved is one that gives rise to speculative abuse."[391]

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[389] *Id*. at 593.

[390] *Id*. at 593. Nt. 24, the Supreme Court observed that the term "unorthodox" transaction "has been applied to stock conversions, exchange pursuant to mergers and other corporate reorganizations, stock reclassifications and dealings in options, rights, and warrants." Citing LOSS, SECURITIES REGULATION, 1069 (2d ed. 1961). *Id*. At 594 Nt. 24.

[391] *Id*. at 594. Applying this rule to the facts of the case, the Supreme Court observed that the exchange of Old Kern stock for Tenneco stock pursuant to the merger was not a "sale" under §16(b). The Supreme Court observed that it is "totally unrealistic to assume or infer from the facts…[T]hat Occidental either had or was likely to have access to inside information, by reason of its ownership of more than 10% of the outstanding shares of Old Kern, so as to afford it an opportunity to reap speculative, short-swing profits from its disposition within six months of its tender-offer purchases." *Id*. at 596. In addition, "[t]here is no basis for finding that, at the time the tender offer was commenced, Occidental enjoyed an insider's opportunity to acquire information about Old Kern's affairs." *Id*. Finally, the Supreme Court concluded that: "We do not suggest that an exchange of stock pursuant to a merger may never result in s 16(b) liability. But the involuntary nature of Occidental's exchange, when coupled with the absence of the possibility of speculative abuse of inside information, convinces us that s 16(b) should not apply to transactions such as this one." *Id*. at 600. In regard to the second allegation, the Supreme Court did not "find in the execution of the Occidental-Tenneco option agreement a sufficient possibility for the speculative abuse of inside information." *Id*. at 601. The Supreme Court realized that the mutual advantage of the agreement was clear. Occidental did not want to be in the position of a minority stockholder with no control and in a company that it had not chosen to invest in. Tenneco did not want to have a "troublesome minority stockholder that had just been vanquished in a fight for the control of Old Kern." *Id*. Therefore the Supreme Court concluded that: "Motivations like these do not smack of insider trading." *Id*. Moreover, the Supreme Court concluded that "the option agreement, as drafted and executed by the parties, offered [no] measurable possibilities for speculative abuse." *Id*. According to the option agreement, Tenneco was not required to buy stock. Occidental could not benefit from the increased market value of Tenneco stock. If the fixed price fell more than $10 per share before the exercising date, the option may not have been exercised, and Occidental may have suffered a loss if the marker value of the stock continued to fall to a point where it was forced to sell. Therefore, the Supreme Court concluded that: "The option[] does not appear to have been an instrument with potential for speculative abuse, whether or not Occidental possessed inside information about the affairs of Old Kern." *Id*. at 602. *See WANG & STEINBERG, supra* note 5, at 998; JACOBS, *supra* note 93, at §4:156.

In their review of subsequent cases and scholarly commentary, Professors William Wang and Marc Steinberg[392] concluded that the pragmatic test is "apparently" applied if the answer to the first of the three following questions is "yes" and the rest are answered "no":

> (1) Is the transaction in question of a type that may be characterized as unorthodox?
> (2) Did the insider have control over the timing of the decision involved in the transaction?
> (3) Did the insider have access to inside information, irrespective of whether that information was in fact used?[393]

<u>Section 16(b) Exemptions</u>

Although Section 16(b) was designed objectively as a "flat-rule" to prevent gaining short-swing profits from speculative trading activities, Congress exempted from Section 16(b) liability any equity securities "acquired in good faith in connection with a debt previously contracted."[394] Congress also exempted transactions that were executed while "such beneficial owner was not such both at the time of the purchase and sale, or the sale and purchase."[395] In addition, Section 16(d) exempted the coverage of bona fide market-making transactions from Sections 16(a), 16(b), and 16(c).[396] Section 16(e) also exempted foreign and domestic arbitrage transactions.[397] Moreover, Congress granted the SEC the

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[392] *WANG & STEINBERG, supra* note 5, at 1004.
[393] *Id.*
[394] Section 16(b) of the Exchange Act of 1934, 15 U.S.C.A. § 78p(b); *Dreiling v. Am. Exp. Co.,* 458 F.3d 942, 947 (9th Cir. 2006).
[395] Section 16(b) of the Exchange Act of 1934, 15 U.S.C.A. § 78p(b).
[396] Section 16(d) of the Exchange Act of 1934, 15 U.S.C.A. § 78p(d); HAZEN, *supra* note 323, at 563. Market making is a "broker-dealer engaged in this practice, which is regulated by both the NASD and the SEC, buys and sells securities as a principal for its own account, and thus accepts two-way bids (both to buy and to sell)." Black's Law Dictionary (10th ed. 2014).
[397] Section 16(e) of the Exchange Act of 1934, 15 U.S.C.A. § 78p(e). Rule 16-e-1 prohibits directors and officers of an issuer to engage in arbitrage transactions in any equity of such issuer, whether registered or not, unless they shall include such transaction in the statements required by Section 16(a) and shall account to such issuer for the profits arising from such transaction, as provided in Section 16(b). However, Section 16(c), which prohibits short-selling and sales against the box, does not apply to such arbitrage transactions. This rule states that other than officer and directors, bona fide foreign or domestic arbitrage transactions are excluded from the coverage of Section 16. Therefore, the exemption includes beneficial owners of more than

regulatory power to exempt transactions "as not comprehended within the purpose of this subsection."[398] On the basis of its regulatory power granted under Section 16(b), the SEC considered whether specific transactions carry "significant risk of abusive insider trading with less informed investors," before finalizing exemptions.[399]

The SEC eventually issued several rules under Section 16(b) containing exemptions from short-swing profit liability for certain transactions that they are deemed to be out of the purpose of the statute.[400] One of the most important rules under Section 16(b) is the requirement of the times of the two matched transactions that trigger Section 16(b) liability. It is noteworthy that Section 16 covers registered securities pursuant to Section 12 of the SEA as well as securities that have not been registered.[401] That said, Section 16(b) requires that the beneficial owner must be in this capacity at the time of the purchase and sale transactions to be liable for short-swing profits.[402] A transaction that makes a beneficial owner a holder of more than 10 percent of the issuer's equity securities is not a covered transaction under Section 16(b).[403] In addition, the sale of the held securities must occur while the beneficial owner is a holder of more than 10 percent.[404] If the beneficial owner

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10 percent who are not officers or directors. Rule 16e-1, 17 C.F.R. §240.16e-1. *See* HAZEN, *supra* note 323, at 563. The term arbitrage means: "the simultaneous buying and selling of identical securities in different markets, with the hope of profiting from the price difference between those markets." Black's Law Dictionary (10th ed. 2014).

[398] *Dreiling v. Am. Ex*, 458 F.3d 942, 947 (9th Cir. 2006); *LANGEVOORT*, *supra* note *6, at* §10:06; HAZEN, *supra* note 323, at 562.

[399] *Dreiling,* 458 F.3d, at 949.

[400] Fransic J. Burke, Jr., *Insider Trading Securities Violations*, ABA Section of Litigation 2012 Corporate Counsel CLE Seminar, 29, (February 16-19, 2012*) available at* https://tinyurl.com/yaq83vpk.

[401] *Id*. (The rules under section 16 of the Act apply to any class of equity securities of an issuer whether or not registered under section 12 of the Act.) *Id*.

[402] *LANGEVOORT, supra* note *6, at* §10:06.

[403] Rule 16a-2(c) 17 C.F.R. §240. 16a-2(c). ("The transaction that results in a person becoming a ten percent beneficial owner is not subject to section 16 of the Act unless the person otherwise is subject to section 16 of the Act.") *Id*. *See WANG & STEINBERG, supra* note 5, at 982.

[404] JACOBS, *supra* note 93, at §4:153; *WANG & STEINBERG, supra* note 5, at 984.

of more than 10 percent purchased and subsequently sold the held securities is a holder of 10 percent or less and the owner continued selling the held securities, the first sale would be matched with the purchase executed within a six-month period, but the second separable sale would not be covered under Section 16(b).[405] In contrast, directors and officers may be subject to short-swing profit liability if one of the two transactions was executed while they were in the position of a director or officer.[406] However, transactions that occur prior to becoming a director or officer are exempted from Section 16 and short-swing profit liability.[407] In contrast, transactions executed in the prior six months of the issuer going public under Section 12 of the SEA are covered under Section 16 including Section 16(b) short-swing profits.[408] Moreover, when an officer or director ceases to be an officer or director, the subsequent transaction that occurred during the next six months from the date of ceasing to be in these capacities is covered under Section 16(b) under two conditions: "(1) [t]he executed [transaction was] within a period of less than six months of an opposite transaction subject to section16(b) of the Act that occurred while that person was a director or officer; and (2) [The executed transaction was not] otherwise exempted from section

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[405] Rule 16a-2(c) 17 C.F.R. §240. 16a-2(c). ("A ten percent beneficial owner not otherwise subject to section 16 of the Act must report only those transactions conducted while the beneficial owner of more than ten percent of a class of equity securities of the issuer registered pursuant to section 12 of the Act.") *Id*. Even though this paragraph exempts them from a reporting requirement under 16(a) for transactions when a beneficial owner is no longer an owner of more than 10 percent, this paragraph also covers §16(b), rule 16a-10 states that "any transaction exempted from the requirements of Section 16(a) of the Act, insofar as otherwise subject to the provisions of section 16(b), shall be likewise exempt from section 16(b) of the Act. Rule 16a-10, 17 C.F.R. §240.16a-10. *See* JACOBS, *supra* note 93, at §4:153; *WANG & STEINBERG, supra* note 5, at 984.

[406] *LANGEVOORT, supra* note *6, at* §10:06.

[407] *WANG & STEINBERG, supra* note 5, at 984.

[408] Rule 16a-2(a), 17 C.F.R. §240.16a-2(a). ("A transaction(s) carried out by a director or officer in the six months prior to the director or officer becoming subject to section 16 of the Act shall be subject to section 16 of the Act and reported on the first required Form 4 only if the transaction(s) occurred within six months of the transaction giving rise to the Form 4 filing obligation and the director or officer became subject to section 16 of the Act solely as a result of the issuer registering a class of equity securities pursuant to section 12 of the Act.") *Id*. *See* JACOBS, *supra* note 93, at §4:153; *WANG & STEINBERG, supra* note 5, at 988.

16(b) of the Act."[409] This different treatment of the short-swing profit liability under Section 16(b) imposed on corporate insiders because of their ownership and insiders because of their position as directors or officers, comes from the perception that directors and officers have access to inside information. Therefore, their trading transactions are more "vulnerable" to misappropriating inside information available to them because of their fiduciary positions. In contrast, owners of more than 10 percent are presumed to have the opportunity to abuse inside information only when they have the requisite ownership percentage that gives them the right to influence the corporation and have access to inside information. When they no longer have more than 10 percent ownership, they are no longer subject to Section 16(b) liability because they are presumed to have no opportunity to acquire inside information.[410]

The second major exemption from Section 16(b) coverage is the securities transactions that occur between a corporate director or officer and the issuer involving the issuer's equity securities.[411] The SEC rule 16b-3 contains four exempted transactions including transactions related to employee benefit plans.[412] The first category of exempted transactions is transactions pursuant to tax-conditioned plans (other than a discretionary

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[409] Rule 16a-2(b), 17 C.F.R. §240.16a-2(b). *See* JACOBS, *id*, at §4:154.
[410] This analysis of the statute is derived from the United States Supreme Court's analysis in F*oremost-McKesson, Inc. v. Provident Securities Co.*, 423 U.S. 232, 253 (1976). ("The legislative discourse revealed that Congress thought that all short-swing trading by directors and officers was vulnerable to abuse because of their intimate involvement in corporate affairs. But trading by mere stockholders was viewed as being subject to abuse only when the size of their holdings afforded the potential for access to corporate information. These different perceptions simply reflect the realities of corporate life.") *Id*. *See WANG & STEINBERG, supra* note 5, at 983.
[411] *See* HAZEN, *supra* note 323, at 562; *WANG & STEINBERG, supra* note 5, at 1016.
[412] This rule, however, is not available to beneficial owners of more than 10 percent who are not directors or officers. *See WANG & STEINBERG, supra* note 5, at 1016; COX ET AL, *supra* note 7, at 945.

transaction).[413] This includes stock appreciation rights or phantom stock.[414] The second category is discretionary transactions[415] that are exempted if they are affected pursuant to an election by the corporate insider that is made at least six months following the date of the most recent "opposite way" election regarding any plan of the issuer.[416] The third exemption involves transactions (other than a discretionary transaction) of grants/awards of securities and other acquisitions from the issuer by directors and officers.[417] For a transaction to be exempted, one of three conditions must be fulfilled, (1) the transaction is approved by the board of directors or by a committee that is composed solely of two or more non-employee directors; (2) the transaction is approved or ratified at a subsequent date no later than the next annual meeting, by a majority of the securities of the entitled to vote under the applicable laws; or (3) the related security is held by the officer or director

[413] Rule 16b-3(c), 17 C.F.R. §240.16b-3(c). Tax-conditioned plans are defined by the rule as: "Any transaction (other than a Discretionary Transaction) pursuant to a Qualified Plan, an Excess Benefit Plan, or a Stock Purchase Plan shall be exempt without condition." An Excess Benefit Plan is: "an employee benefit plan that is operated in conjunction with a Qualified Plan, and provides only the benefits or contributions that would be provided under a Qualified Plan but for any benefit or contribution limitations set forth in the Internal Revenue Code of 1986, or any successor provisions thereof." Rule 16b-3(b)(2), 17 C.F.R. §240.16b-3(b)(2). A Qualified Plan means: "an employee benefit plan that satisfies the coverage and participation requirements of sections 410 and 401(a)(26) of the Internal Revenue Code of 1986, or any successor provisions thereof." Rule 16b-3(b)(4), 17 C.F.R. §240.16b-3(b)(4). A Stock Purchase Plan means: "an employee benefit plan that satisfies the coverage and participation requirements of sections 423(b)(3) and 423(b)(5), or section 410, of the Internal Revenue Code of 1986, or any successor provisions thereof." Rule 16b-3(b)(5), 17 C.F.R. §240.16b-3(b)(5).

[414] HAZEN, *supra* note 323, at 562. Stock appreciation right is: "[a] right, typically granted in tandem with a stock option, to be paid the option value (in cash) when exercised along with the simultaneous cancellation of the option." Black's Law Dictionary (10th ed. 2014). Phantom Stock is "[i]maginary stock that is credited to a corporation executive account as part of the executive's compensation package." Stock, Black's Law Dictionary (10th ed. 2014) *available at* West Law. Phantom stock plan is a "long-term benefit plan under which a corporate employee is given units having the same characteristics as the employer's stock shares. It is termed a 'phantom' plan because the employee does not actually hold any shares but instead holds the right to the value of those shares." Black's Law Dictionary (10th ed. 2014).

[415] Rule 16b-3(b)(1) defines, in general, a discretionary transaction as a transaction pursuant to an employee benefit plan that "results in either an intra-plan transfer involving an issuer equity security fund, or cash distribution funded by a volitional disposition of an issuer equity security." Rule 16b-3(b)(1), 17 C.F.R. §240.16b-3(b)(1). *See WANG & STEINBERG, supra* note 5, at 1016.

[416] Rule 16b-3(f), 17 C.F.R. §240.16b-3(f); *WANG & STEINBERG, supra* note 5, at 1017.

[417] Rule 16b-3(d), 17 C.F.R. §240.16b-3(d).

for no less than six months following the date of the acquisition.[418] The last exempted securities transactions under SEC rule 16b-3 are transactions that involve the disposition to the issuer (other than a discretionary transaction).[419] Transactions that involve the disposition to the issuer of issuer equity security are exempted from the coverage of Section 16(b) if the disposition is approved in advance in which it meets one of the first two conditions of exempting acquisitions from the issuer stated in paragraph (d)(1) or (d)(2) of the Rule 16a-3(d).[420]

Other exemptions from the coverage of Section 16(b) short-swing profit liability are the acquisition and disposition of bona fide gifts and inheritance of securities. The acquisition or disposition of securities pursuant to a merger, reclassifications, consolidation in exchange for securities of a company that before such exchange owned 85 percent or more of the equity securities of all other companies party to the merger or consolidation, or 85 percent of the combined assets of all companies undergoing a merger or consolidation.[421] In addition, the exercise or conversion of derivative securities, other than the acquisition or disposition, are exempted from Section 16(b) coverage. [422]

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[418] Rule 16b-3(d)(1), (2), (3), 17 C.F.R. §240.16b-3(d)(1), (2), (3). *See WANG & STEINBERG, supra* note 5, at 1018.

[419] Rule 16b-3(e), 17 C.F.R. §240.16b-3(e)

[420] Either the disposition is approved by (1) "the board of directors of the issuer, or a committee of the board of directors that is composed solely of two or more Non-employee Directors;" or (2) "the affirmative votes of the holder of a majority of the securities of the issuer present, or represented, and entitled to vote at a meeting duly held in accordance with the applicable laws." Rule 16b-3(d)(1), (2), 17 C.F.R. §240.16b-3(d)(1), (2). *See WANG &* STEINBERG, at 1021.

[421] Rule 16-b (7)(1), (2), 17 C.F.R. §240.16b-(7)(1), (2); SEC. EXCH. COMM'N, RELEASE NO. 33-8600, OWNERSHIP REPORTS AND TRADING BY OFFICERS, DIRECTORS AND PRINCIPAL SECURITY HOLDERS, SEC. (Aug. 3, 2005); HAZEN, *supra* note 323, at 563.

[422] Rule 16-b(6)(b), 17 C.F.R. §240.16b-(6)(b). *See WANG & STEINBERG, supra* note 5, at 1004. The exemptions include an increase or decrease in the number of securities held as a result of a stock split or stock dividend applying equally to all securities of a class, and the acquisition of rights including pre-emptive rights pursuant to a pro rata grant to all holders of the same class of equity security. Rule 16a-9(a),(b), 17 C.F.R. §240.16a-9(a),(b). In addition, the acquisition or disposition of equity securities involved in the deposits or withdrawals from a voting trust or deposit agreement is exempted from Section 16(b) coverage. Rule 16b-8,

Summary

Part 2 part explores Section 16 of the SEA, which is the only U.S. statutory provision governing corporate insider trading. In particular, this part discusses the two major mechanisms that Section 16 was intended to apply: the duty to report beneficial ownership under subdivision (a) of Section 16 and the private liability for gaining short-swing profits under subdivision (b) of this section.

Section 16 defines corporate insiders to include directors, certain officers, and beneficial owners of more than 10 percent of equity security of an issuer registered pursuant to Section 12 of the SEA. The SEC's determination of these insiders focused on whether a person has actual or potential control over the issuer that allows such a person to have legal access to inside information. The requirement of disclosure of security ownership imposed upon corporate insiders goes beyond what these insiders actually own but includes any equity security in which they have or share an economic interest including securities held by immediate family members. Corporate insiders are required to report in a timely manner once they become subject to Section 16 and when there is a change in their beneficial ownership.

Corporate insiders are deemed civilly liable under Section 16(b) when they gain short-swing profits realized from the purchase and sale (or sale and purchase) within a six-month period. However, there are several exemptions from such liability because of the nature of the two matched transactions where one of the transactions involves a

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17 C.F.R. §240.16b-8. The acquisition of securities resulting from the reinvestment of dividends or interest on securities of the same issuer is also exempted from section 16 including §16(b) coverage if the plan is made for the regular reinvestment of dividends or interest and the plan provides for broad-based participation, does not discriminate in favor of employees of the issuer, and operates on substantially the same terms for all plan participants. Rule 16a-11, 17 C.F.R. §240.16a-11. For more discussion about the exemptions from the coverage of §16(b) *see also* HAZEN, *supra* note 323, at 563; *Burke*, *supra* note 400, at 29.

nontraditional purchase or sale, or other transactions that are deemed not to involve abusive trading conduct by the insider.

While Section 16 was designed to prevent corporate insiders from abusing their privy position inside the issuer by using inside information for personal benefit in breach of their fiduciary duty, Section 16 does not prohibit insiders from trading on the basis of inside information. The next part discusses this issue of whether corporate insiders are prohibited from having an informational advantage over public investors by trading on material non-public information while such information has not been publicly disclosed.

Part 3. Illegal Corporate Insider Trading Regulations

Introduction

Unlike many countries, the United States has no statutory provisions that expressly prohibit corporate insiders or their tippees from trading in their corporations' stock on the basis of material non-public information.[423] Nevertheless, the regulation of illegal corporate insider trading has been a concern for judicial theories and administrative rules along with congressional attempts to expressly rationalize and regularize the prohibition of this type of trading.[424] In 1988, Congress considered enacting a statutory definition for illegal corporate insider trading but decided to avoid codifying such a definition because

[423] *See Painter et al., supra* note *257*, 211; Donna M. Nagy, *Insider Trading and the Gradual Demise of Fiduciary Principles*, 94 Iowa L. Rev. 1315, 1366 (2009).

[424] The United States Congress has attempted to regulate illegal corporate insider trading multiple times, but none of these attempts have been successful. Congress enacted the Insider Trading Sanctions Act of 1984 and Insider Trading and Securities Fraud Enforcement Act of 1988 to fill the gap in important aspects under corporate illegal insider trading law and to increase the sanctions for violations. However, Congress did not offer a definition to explain the illegal conduct and the persons subject to the prohibition. In 1987, the Senate and the House proposed bills to define illegal insider trading. In the Insider Trading Prevention Act of 1987, H.R. 1238, 100th Cong. (1987), and Insider Trading Proscriptions Act of 1987, S. 1380, 100th Cong. (1987). However, the SEC and the Senate and House were divided on whether contemporaneous traders have private right of action against illegal insider trading or if it is only a criminal act. They also disagreed about whether an insider must use the inside information in his trade or if it is enough that the insider is in possession of such information. This attempt did not produce legislative action. *See* Cindy A. Schipani; H. Nejat Seyhun, *Defining Material, Nonpublic: What Should Constitute Illegal Insider Information*, 21 Fordham J. Corp. & Fin. L. 335 (2016). In 2015, there were two bills. One was introduced in the House, Ban Insider Trading Act of 2015, and the other one was introduced in the Senate, Stop Illegal Insider Trading Act of 2015. The proposed legislation in the House proposed an amendment to Section 10 of the SEA to make it unlawful under a new paragraph (d) (1) for any person to purchase or sell any security on the basis of material inside information that is not available to the public. The bill also states that nothing in this bill may be construed to effect liability under section 10(b). The bill defines "inside information" as information that is (1) non-public; (2) obtained illegally, directly or indirectly from an issuer with an expectation of confidentiality or that such information only be used for a legitimate business purpose; or (3) in violation of a fiduciary duty. The Ban Insider Trading Act, H.R. 1173, 114th Cong. §(a) (2015) The other bill introduced in the Senate makes "it unlawful for any person to: (1) purchase, sell, or cause the purchase or sale of any security on the basis of material information that the person knows or has reason to know is not publicly available; or (2) knowingly or recklessly communicate material information that the person knows or has reason to know is not publicly available to any other person under circumstances in which it is reasonably foreseeable that the communication is likely to result in a violation of this prohibition." The Stop Illegal Insider Trading Act, S.702, 114th Cong. (2015). For more discussion about the two bills, *see* Shannon Seaforth, *No More Quid Pro Quo: Abandoning the Personal Benefit Requirement in Insider Trading Law*, 50 U. Mich. J. L. Reform 175, 201 (2016).

of the negative effect. It "could potentially be narrowing," and used as a blueprint to evade the law by unscrupulous traders.[425] Congress also noticed that the courts had drawn the parameters of illegal corporate insider trading and established clear guidelines and widely known principles for the vast majority of traditional illegal corporate insider trading cases.[426]

The law that governs illegal corporate insider trading is a judge-made law on the basis of the interpretation of broad language under Section 10(b) of the SEA and Rule 10b-5, promulgated thereunder. Section 10(b) reads as follows:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce of the mails, or of any facility of any national securities exchange…(b) to use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered or any securities based swap agreement any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commissions may prescribe as necessary or appropriate in the public interest or for the protection of investors.[427]

Rule 10b-5 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, a. To employ any device, scheme, or artifice to defraud, 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 the light of the circumstances under which they were made, not misleading, or 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.[428]

The absence of an express statutory provision regulating illegal corporate insider trading resulted in the lack of a statutory definition to determine the prohibited conduct and

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[425] Insider Trading and Securities Fraud Enforcement Act of 1988, the Committee on Energy and Commerce to the Whole House on the State of the Union, 100-910, 10th 2d Cong. (1988), at 11.

[426] *Id. See* Roberta S. Karmel, *the Law on Insider Trading Lacks Needed Definition*, 68 SMU L. Rev. 757, 766 (2015); Oliver Perry Colvin, *A Dynamic Definition of and Prohibition Against Insider Trading*, 31 SANTA CLARA L. REV. 603-617 (1991). For more discussion about legislative recommendations by commentators, *see Painter et al., supra* note *257*, at 200.

[427] *15 U.S.C.A. §78j.*

[428] *17 C.F.R. § 240.*

what constitutes material non-public information.[429] As a result, there are several theories about who is subject to the prohibition of trading on the basis of material non-public information along with divided opinions about the extent of this prohibition. In fact, the prohibition of trading on the basis of material non-public information has been expanded to cover not only corporate insiders, but also outsiders who are strangers to the corporation and its shareholders.[430]

Although nothing in the language of Section 10(b) or Rule 10b-5 refers to the imposition of prohibition upon corporate insiders or others to trade on the basis of material non-public information, the SEC, at first and later the courts, construed Rule 10b-5 as it prohibits this trading conduct. In particular, it establishes a practice that operates or would operate as fraud or deceit in connection with the purchase or sale of a security.[431]

This part seeks to determine the regulations of illegal corporate insider trading in the United States federal securities laws. It begins with a discussion of the language of Section 10(b) of the SEA and Rule 10b-5 and how the language of Rule 10b-5 has been interpreted to prohibit corporate insiders and their tippees from trading on material non-public information. This part goes on to determine who is subject to the prohibition of illegal corporate insider trading by examining the judicial insider trading theories. In most instances, these theories constitute the law about illegal corporate insider trading. This part follows the discussion of the definition of material non-public information based on the judicial and administrative determination and the required level of a "culpable state of mind" regarding knowledge about material non-public information.

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[429] *See Painter et al.,* at 211.
[430] HAZEN, *supra* note 2, at §12:160.
[431] *Chiarella v. United States*, 445 U.S. 222, 226-223 (1980).

Early Development of the Illegal Corporate Insider Trading Doctrine

Corporate illegal corporate insider trading was developed in case-law before the enactment of the federal securities laws in 1930s. Therefore, a brief overview of the early common law opinions regarding corporate insider trading with shareholders without the disclosure of material non-public information can help us to understand the background of the development of the law under Rule 10b-5.[432]

Common Law Action for Deceit—Non-disclosure[433]

To make a claim under common law tort action for deceit,[434] the allegation must show that the defendant has intentionally misrepresented a material fact or non-complete true statement that made the statement misleading (half-truth).[435] However, the mere non-disclosure of a material fact was not actionable under common law action for deceit unless

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432 *See LANGEVOORT, supra* note 6, *at* §2:2.

433 Common law means: "The body of law derived from judicial decisions, rather than from statutes or constitutions." Common Law, Black's Law Dictionary (10th ed. 2014).

434 In torts law, fraud, deceit, and misrepresentation are used interchangeably as the name of the economic tort. DOBBS ET AL, *supra* note 206, at 1117.

435 The other elements of the common law action for deceit are as follows: The false statement was with the intent to induce reliance in the representation; the plaintiff acted in reliance on the false statement which was justified to rely on; and the false statement was the proximate cause of resulting pecuniary harm to the plaintiff. DOBBS ET AL, *supra* note 206, at 1118. The Restatement (First) of Torts, states that "[o]ne who fraudulently makes a misrepresentation of fact, opinion, intention or law for the purpose of inducing another to act or refrain from action in reliance thereon in a business transaction is liable to the other for the harm caused to him by his justifiable reliance upon the misrepresentation." Restatement (First) of Torts § 525 (1938). The Restatement (Third) of Torts provides a similar definition of fraud. It states that "[o]ne who fraudulently makes a material misrepresentation of fact, opinion, intention, or law, for the purpose of inducing another to act or refrain from acting, is subject to liability for economic loss caused by the other's justifiable reliance on the misrepresentation." Restatement (Third) of Torts: Liability for Economic Harm § 9 TD No 2 (2014). *See*, DOBBS ET AL, at 1118, Nt. (45); *Loss*, *Supra* note 266, at 1430; Ellen Virginia Hines, *A New Concept of Fraud on the Securities Exchange—A Comment on In Re Cady Roberts & Co.*, 15 S. C. L. Rev. 557, 568 (1962); MARSHALL S. SHAPO, PRINCIPLES OF TORT LAW, 79 (4th ed. 2016). citing *Hanson v. Ford Motor CO.*, 278 F.2d 586, 590-91 (8th Cir. 1960). ("A person is liable for fraud if he makes a false representation of a past or existing material fact susceptible of knowledge, knowing it to be false, or as of his own knowledge without knowing whether it is true or false, with intention to induce the person to whom it is made to act in reliance upon it, or under such circumstances that such person is justified in acting in reliance upon it, and such person is thereby deceived and induced to act in reliance upon it, to his pecuniary damage." *Id*.

there was a duty to disclose arising from a fiduciary or confidential relationship between the parties in question.[436] Finding that a non-disclosure of a material fact was a fraud because of the fiduciary or confidential relationship (constructive fraud) between the parties was even narrower and more limited and did not cover all fiduciary or confidential relationships.[437]

In the corporate context, three opinions divided the courts on whether the relationship between the corporate insiders and shareholders was sufficient to impose a duty to disclose when corporate insiders deal in their corporations' stock with the shareholders.[438] The first opinion was the majority opinion or what was described as the "strict" rule.[439] The majority opinion in common law found that corporate insiders have a

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[436] The Restatement (First) of Torts states that: "(1) One who fails to disclose to another a thing which he knows may justifiably induce the other to act or refrain from acting in a business transaction is subject to the same liability to the other as though he had represented the nonexistence of the matter which he has failed to disclose, if, but only if, he is under a duty to the other to exercise reasonable care to disclose the matter in question. (2) One party to a business transaction is under a duty to exercise reasonable care to disclose to the other before the transaction is consummated (a) such matter as the other is entitled to know because of a fiduciary or other similar relation of trust and confidence between them." Restatement (First) of Torts § 551 (1938). Under common law fraud, there were other scenarios that impose a duty to disclose but were distinguished from mere "non-disclosure." Professor Werdner Page Keeton enumerated three fact-situations that courts found as a failure to disclose actionable under common law fraud and were distinguished from mere "non-disclosure." These fact-situations are: (1) active concealment which constitutes both words and acts for the purpose of preventing "the other from ascertaining some material fact which he would have discovered had it not been for the interference"; (2) failing to correct statements which were true statements when it was made but it is, subsequently, discovered to be false, or they were false but the representor did not know that the statement was false; (3) when good faith requires one to correct a misrepresentation made by third persons. W. Page Keeton, *Fraud – Concealment and Non-Disclosure*, 3 Current Legal Thought 315 (1937) citing *McGinn v. McGinn*, 50 R.I. 278, 146 Atl. 626 (1929), *O'Leary v. Tillinghast*, 22 R.I.161, 46 Atl. 754 (1900), and *Aortson v. Ridgway*, 181 III, 23 (1856). In this regard, the Restatement (First) of Torts imposed a duty to disclose of "(b) any subsequently acquired information which he recognizes as making untrue or misleading a previous representation which when made was true or believed to be so, (c) the falsity of a misrepresentation which when made was not made for the purpose of its being acted upon if he subsequently ascertains that the other is about to act in reliance upon it in a transaction with him." Restatement (First) of Torts § 551 (1938). *See* also *LOSS*, *supra* note 266, at 1434.

[437] *Keeton*, at *supra* note 436, at 317.

[438] *See LOSS*, *supra* note 266, at 1446; *Hines*, *supra* note 435, at 561; Roberts Walker, *The Duty of Disclosure by a Director purchasing Stock from his Stockholders*, 32 Yale L. J. 637 (1923); *LANGEVOORT*, *supra* note 6, at §2:2; *Keeton*, at 317.

[439] *LOSS*, *supra* note 266, at 1446; Hines, at 561.

fiduciary duty to disclose material non-public information to the shareholder only when they deal with the shareholders on behalf of the corporation.[440] However, corporate insiders do not have a fiduciary duty owed to the shareholders individually.[441] Thus, they are not under a duty to disclose material non-public information when they personally trade in the corporation's stock with the shareholders unless they engage in affirmative misrepresentation, half-truth, or active concealment.[442] The second opinion in common law was the minority opinion or the "fiduciary" rule.[443] This opinion stated that corporate insiders assume fiduciary duty when they deal with the corporate shareholders. Therefore, they must make a full disclosure of material facts that are not readily available to the shareholder.[444] The third opinion in common law was the "special circumstances"

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[440] *LOSS*, *supra* note 266, at 1446; Hines, at 561; *LANGEVOORT, supra* note *6, at* §2:2.
[441] *Id.*
[442] The major case for this opinion is *Carpenter V. Danforth*, 52 Barb. 581, 584 (N.Y. Sup. Ct. 1868). (The Supreme Court of New York stated that directors are in a trust relation with the stockholders "only to the management of the general affairs of the corporation, with a view to dividends of profit, and therefore that the trust relation between the stockholder and director extended no further." *Id*. The court concluded that the sale of stock by a shareholder to a director is not subject to the trust relation between them requiring the director to disclose every fact known to him to the seller because there is no confidential relation between the stockholder and director. The sale of the shareholder's stock "was not the subject of trust between them, nor had the trust relation between them any connection with the shareholder's stock, except so far as the good or bad management of the general affairs of a corporation by its directors, indirectly affects the value of its stock .") *Id*.
[443] *LOSS*, *supra* note 266, at 1446; *Hines*, *supra* note 435, at 562; *LANGEVOORT, supra* note *6, at* §2:2.
[444] The major case for this opinion was *Oliver v. Oliver*, 118 Ga. 362, 45 S.E. 232 (1903). (The Supreme Court of Georgia found that the fact that corporate directors are trustees for the corporation and all shareholders collectively does not mean that they do not have fiduciary duty to disclose to shareholders individually. The Court ruled that each stockholder has undivided interest in the property of the corporation. Therefore, "[t]he fact that he must serve the company does not warrant him in becoming the active and successful opponent of…who in the last analysis are the real parties at interest. No process of reasoning and no amount of argument can destroy the fact that the director is, in a most important and legitimate sense, trustee for the stockholder." *Id.*, at 233. The Court described inside information as "a quasi asset of the company and the shareholder is as much entitled to the advantage of that sort of an asset as to any other regularly entered on the list of the company's holding." *Id.*, at 234. The Court held that if the inside information at the hand of the director is "of a character calculated to affect the selling price," the director must make a full disclosure before dealing with the shareholders, and if the director is under an obligation to the corporation to not disclose such information, the director must refrain from dealing with the shareholders.) *Id*.

doctrine.[445] This doctrine was adopted by some courts as an "in-between decision"[446] which held that even though corporate insiders are not in a fiduciary relationship with the shareholders individually, they have a duty to disclose to the shareholders with whom they deal when special facts in regard to the value of the shares are present.[447] It is important to mention that the common law majority opinion has emerged into the special circumstances doctrine.[448] In addition, the "special circumstances" doctrine and the later majority rule treated the relationship between corporate insiders and shareholders as a special type of relationship that is not fiduciary in character and is also different from the relationship between arm's length traders.[449]

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445 *LOSS*, *supra* note 266, at 1447; *Hines*, *supra* note 435, at 562; *LANGEVOORT, supra* note *6, at* §2:2.
446 *Loss*, at 1447.
447 The major case for this opinion was *Strong v. Repide*, 213 U.S. 419 (1909). (The United Sates Supreme Court found that a defendant (a corporate director and manager) who purchased the plaintiff shares without disclosing an extreme profitable contract and concealed his identity in which the shares were artificially bought by his agent "was fraudulent because the director concealed from the plaintiff's agent facts affecting the value of the stock which the defendant was in good faith bound to reveal." *Id.*, at 422 The special facts were that the defendant was a director of the corporation, the owner of three-fourth of the shares in the company, the general manager of the company, and he was leading the negotiations that led to the sale of the only valuable assets of the company which was the company's lands at a price that resulted in the increase of the value of the stock. The defendant was acting in this negotiation as an owner in his part of the company and as an agent of the other shareholders. The details of the deal and its probability was unknown to any other shareholders except the director. In addition, the director concealed his identity from the plaintiff to avoid any affirmative misrepresentation and the concealment continued by giving a check from a third person for the purchase money. *Id.*at 431-32. While agreeing that corporate directors do not owe fiduciary duty to individual shareholders in regard to their shares in the corporation, the Supreme Court concluded that "under the circumstances detailed, there was a legal obligation on the part of the defendant to make these disclosures." *Id.* at 434. *See LOSS*, *supra* note 266, at 1447.
448 The Supreme Court of Michigan, in *Buckley v. Buckley*, 230 Mich. 504, 508 (1925), emphasized that the general rule is that directors do not have fiduciary duty when they deal directly with the shareholders, and the mere non-disclosure of material facts without more is not sufficient to constitute fraud. However, the Court ruled that this general rule is subject to modification in certain exceptional circumstances. The Court defined this exceptional modification to the general rule as: "special circumstances producing exceptional cases seem to be an assured sale, merger, or other fact or condition enhancing the value of the stock, known by the officer or officers, not known by the stockholder, and not to be ascertained by an inspection of the books. *Id*.
449 *LOSS*, at 1446. (Professor Loss commented about *Strong v. Repide* by stating that "'special circumstances' were found in this case…because the defendant was entrusted with the negotiation to sell the corporate assets, but certainly if he had not been a director he never would have had an affirmative duty to make disclosure.") *Id*. *See Hines*, *supra* note 435, at 563.

Early Development of Illegal Insider Trading under Rule 10b-5

Section 10(b) is a broad statutory provision that Congress added to the SEA as a powerful weapon to catch all types of deceptive and manipulative practices that were known before the enactment of the SEA or thereafter. However, the legislative history of Section 10(b) does little to exhibit the intention of Congress over its extent or the meaning of its terms.[450] The available legislative history shows that the addition of this section was to empower the SEC to confront new types of manipulative or deceptive practices that emerged so it would not have any regulatory obstacles because of some restricted statutory provisions within the SEA.[451]

After enacting the SEA, Section 10(b) remained a non-operative section in that it depended on the SEC regulatory authority to operate Section 10(b).[452] This section granted the SEC the regulatory power to issue rules and regulations that prohibit any deceptive or manipulative practices in connection with the purchase or sale of a security.[453] Eventually, in 1942, the SEC used its regulatory power and issued regulations under Section 10(b),

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[450] The earlier draft of Seciton10(b) of the SEA was inserted as subsection (c) under Section 9 which was a broader version than the current one. Section 9(c) focused solely on prohibiting the use of manipulative devices in connection with the purchase or sale of a security. The older version read "(c) To use or employ in connection with the purchase or sale of any security registered on a national securities exchange any device or contrivance which, or any device or contrivance in a way or manner which the Commission may by its rules and regulations find detrimental to the public interest or to the proper protection of investors." Stock Exchange Regulation: H.R. 7852, 73D Cong 2nd Sess. Section 9(c)(1934). *LOSS*, *supra* note 266, at 1424; WILLIAM H. PAINTER, THE FEDERAL SECURITIES CODE AND CORPORATE DISCLOSURE, 254 (1979).

[451] The only legislative piece disclosed that Section 10(b) was that "of course subsection () (b) is a catch-all clause to prevent manipulative devices I do not think there is any objection to that kind of clause. The commission should have the authority to deal with new manipulative devices." Stock Exchange Regulation Hearings before House Committee on Interstate & Foreign commerce on H.R. 7852 and H.R. 8720, 73d Cong., 2d Sess. 115 (1934) (statement of Thomas G. Corcoran, a draftsman of the Statute) [H.R. 7852 and H.R. 8720, 73d Cong., 2d Sess.]. The Supreme Court, in S*anta Fe Industries, Inc. V. Green,* 430 U.S. 462, 473 Nt (13) (1977), stated that: "The only specific reference to § 10 in the Senate Report on the 1934 Act merely states that the section was 'aimed at those manipulative and deceptive practices which have been demonstrated to fulfill no useful function.'." *Id*. Citing S.Rep.No.792, 73d Cong., 2d Sess., 6 (1934).

[452] PAINTER, *supra* note 450, at 254.

[453] *Id*; *LOSS*, *supra* note 266, at 1426.

Rule 10b-5.[454] The apparent purpose of the issuance of this rule was to close a legal loophole within the SEA.[455] The gap was that there was no provision within the SEA that prohibited fraudulent purchases of securities by any person other than brokers and dealers.[456] The SEC clarified its motivation behind the promulgation of Rule 10b-5 in the release of its decision stating that:

> The Securities and Exchange Commission today announced the adoption of a rule prohibiting fraud by any person in connection with the purchase of securities. The previously existing rules against fraud in the purchase of securities applied only to brokers and dealers. The new rule closes a loophole in the protections against fraud administered by the Commission by prohibiting individuals or companies from buying securities if they engage in fraud in their purchase.[457]

As Milton V. Freeman the drafter of the rule described, the goal of enacting this rule was that "a very simple Rule…outlaws fraud in securities transactions."[458] However, corporate illegal corporate insider trading was not considered nor was it intended to be prohibited under Rule 10b-5.[459]

The development of Rule 10b-5 was not consistent or clear from the beginning due to the simplicity of the intent of the drafters of this rule.[460] In subsequent years after the

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454 *Id.*
455 *Id.*
456 *LOSS*, at 1426.
457 SEC. EXCH. COMM'N, RELEASE NO. *3230*, SECURITIES EXCHANGE ACT OF 1934 *(May. 21, 1942)*, http://3197d6d14b5f19f2f440-5e13d29c4c016cf96cbbfd197c579b45.r81.cf1.rackcdn.com/collection/papers/1940/1942_0521_SEC_PR_RuleX_10b5.pdf. The story of the purpose of enacting Rule 10b-5 was retold by the drafter of the Rule, Milton Freeman. Mr. Freeman was working as an assistant solicitor at the SEC, in 1942. He asserted that the purpose of promulgating Rule 10b-5 was as a reaction to a Boston company president who was purchasing shares from the shareholders and telling them that the company was doing badly, but, in truth, it was not. Mr. Freeman stated that I was asked what to do to prevent such a practice. With help from some SEC staff, he drafted Rule 10b-5. Mr. Freeman said that: "I looked at Section 10(b) and I looked at Section 17, and I put them together." The only discussion that SEC staff had about Rule 10b-5 was where the phrase "in connection with the purchase or sale" should be placed. The staff agreed that it should be at the end of the rule. Milton V. Freeman, *Administrative procedures*, 22 Bus. Law. 891, 921 (1966). *See Painter et al., supra* note *257*, at 160 Nt. 29.
458 Milton V. Freeman, *Foreword*, 61 Fordham, L. Rev. S1, S5 (1993).
459 *Painter et al., supra* note *257*, at 160 Nt. 29)
460 PAINTER, *supra* note 450, at 254.

issuance of Rule 10b-5, judges and lawyers interacted with this rule based on the already established rules under common law fraud or tort action for deceit.[461] These rules were established because anti-fraud provisions were built essentially on common law action for deceit, and were due to the novelty of these statutory provisions.[462] However, courts also considered that even though Rule 10b-5 was found to be built on common law fraud, the definition of fraud under Rule 10b-5 is not limited to actionable fraud circumstances that arise under common law.[463] Nevertheless, the boundaries of circumstances that can be classified as fraudulent practices under Rule 10b-5 were not clear at that time.[464]

In the 1960s, the development of Rule 10b-5 was influenced by a notable legal movement advocating for a federal intervention to protect investors by regulating the relationship between corporate management and shareholders.[465] In particular, they urged lawmakers to prevent corporate insiders from taking unfair advantage of their position at the expense of corporate shareholders.[466] They called for a broad interpretation of Rule 10b-5 to outlaw not only ordinarily fraudulent practices as established in common law fraud, but also unfair corporate transactions including a breach of fiduciary duty by corporate insiders when they deal in the corporation's stock with the shareholders.[467]

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[461] *LOSS*, *supra* note 266, at 1430.
[462] *Id.*
[463] *Id.*at 1435.
[464] *LOSS*, *supra* note 266, at 1435. (Professor Luis Loss suggested that the determination of how much further Rule 10b-5 could go beyond common law action for deceit "is difficult to say definitely." *Id*. Professor Loss found that the basic problems that arise under Rule 10b-5 are similar to the issues that arise under common law action for deceit and he suggested that: "It seems reasonable to assume at the very least that the most liberal common law views on these questions should govern under the statutes." *Id*. Professor Loss enumerated three basic problems that arise under both common law action for deceit and Rule 10b-5. These problems are the determination of (1) what is false; (2) what is fact; and (3) what is material.) *Id*.
[465] PAINTER, *supra* note 450, at 255.
[466] *Id*.
[467] *See Id*; *Hines*, *supra* note 435, at 565. (Professor Hines suggested that "[t]he anti-fraud provisions, especially Rule 10b-5, provide a broad framework within which the courts and the Securities Exchange Commission may prohibit any practice or device which they might deem unfair." *Id*.

However, most parts of this broad approach were defeated by multiple decisions from the United States Supreme Court.[468] Specifically, the Supreme Court established a clear and sharp rule for one of the most repeated and critical problems that arose under the discussion of the scope of Rule 10b-5 regarding corporate mismanagement's conduct and breach of fiduciary duty by directors and managers.[469] In *Santa Fe Industries, Inc. V. Green,*[470] the Supreme Court ruled that a breach of corporate insider's fiduciary duty can be actionable under Rule 10b-5 only if the breach also constitutes deception or manipulation in

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[468] PAINTER, *supra* note 450, at 256; Steve Thel, *The Original Conception of Section 10(b) of the Securities Exchange Act,* 42 Sta. L. Rev. 385(1990). *See* for e.g., *Birnbaum v. Newport Steel Corp.*, 193 F.2d 461, (U.S. 1952). (The United States Supreme Court stated that minority shareholders do not have a standing to sue under Rule 10b-5 for an allegation regarding the control sale by a director of a corporation and its controlling shareholder that was alleged to result in the breach of fiduciary duty and certain misrepresentations by the director. The Supreme Court rejected the plaintiffs' allegations since they were not purchasers or sellers of the securities in question. The Supreme Court stated that "[w]hen Congress intended to protect the stockholders of a corporation against a breach of fiduciary duty by corporate insiders, it left no doubt as to its meaning. Thus Section 16(b) of the Act of 1934, 15 U.S.C.A. 78p(b) expressly gave the corporate issuer or its stockholders a right of action against corporate insiders using their position to profit in the sale or exchange of corporate securities. The absence of a similar provision in Section 10(b) strengthens the conclusion that that section was directed solely at that type of misrepresentation or fraudulent practice usually associated with the sale or purchase of securities rather than at fraudulent mismanagement of corporate affairs, and that Rule X-10B-5 extended protection only to the defrauded purchaser or seller.") *Id.*at 464; *Superintendent of Insurance. Of States of N/Y. v. Bankers Life & Cas. Co.*, 404 U.S. 6 (1971). (The United States Supreme Court found that when a corporation was duped into selling its stock by a fraudulent scheme by its president and others it has standing to sue under Section 10(b) and Rule 10b-5 since "there was a 'sale' of a security and since fraud was used 'in connection with' it, there is redress under s 10(b)." *Id.*at 12. The Supreme Court, in this case held, basically, that the form of fraud or deception must be in connection with the purchase or sale of a security whether the form of fraud committed was usually associated with the purchase or sale of a security or was a new type of fraudulent scheme disregarding whether the new type also involves a breach of fiduciary duty which gives the plaintiff the right to *see*k state remedy.) *Id.*at 10, Nt (7); *Santa Fe Industries, Inc. V. Green,* 430 U.S. 462 (1977). (The Supreme Court rejected the allegation that a breach of fiduciary duty by majority shareholders by unfairly appraising the minority shareholders' stock in a squeeze-out merger is actionable under Rule 10b-5. The Supreme Court found that mismanagement and breach of fiduciary duty by corporate insiders alone is not enough to find deceptive or manipulative conduct under Rule 10b-5. *Id*. at 476. The Supreme Court rejected the proposition of the Court of Appeals and the plaintiff that a breach of fiduciary duty by majority stockholders, without any deception, misrepresentation, or nondisclosure violates the statute and Rule 10b-5. *Id*. In regard to the rejection of finding a manipulative practice in the allegation of the plaintiff, the Supreme Court stated that "[n]o doubt Congress meant to prohibit the full range of ingenious devices that might be used to manipulate securities prices. But we do not think it would have chosen this 'term of art' if it had meant to bring with the scope of s 10(b) instances of corporate mismanagement such as this, in which the essence of the complaint is that shareholders were treated unfairly by a fiduciary." Id. at 477.

[469] PAINTER, *supra* note 450, at 255.

[470] 430 U.S. 462 (1977).

connection with the purchase or sale of a security.[471] In summary, the Supreme Court has limited the scoop of Rule 10b-5 to be strictly interpreted in light of the specific terms under Section 10(b) which prohibits only the use of deceptive or manipulative devices in connection with the purchase or sale of a security. The Supreme Court also provided that mismanagement and a breach of fiduciary duty without misrepresentation or full non-disclosure is not considered deceptive conduct under Rule 10b-5.[472]

<u>The SEC Declared that Trading on Material Non-Public Information Is Fraud—The Abstain or Disclose Doctrine</u>

The turning point in the history of illegal corporate insider trading was when William L. Carry became the chairman of the SEC on March 27, 1961.[473] In the 1960s, Chairman Carry was one of the main players in the legal movement, which was advocating for strong "self-restraint and accountability" in corporate law and securities markets.[474] The concept was that insiders who have access to inside information should be prevented from pursuing self-interest by abusing inside information in violation of their responsibility

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[471] *See Santa Fe Industries, Inc.* (The Supreme Court in this case stated plainly that the language of Section 10(b) controls the interpretation of Rule 10b-5. In addition, the Court stated that the SEC was given authority to "adopt regulations to carry into effect the will of Congress as expressed by the statute," *Id.* at 472, not the power to make law. *Id.* Then, the Supreme Court stated that: "'When a statute speaks so specifically in terms of manipulation and deception, . . . and when its history reflects no more expansive intent, we are quite unwilling to extend the scope of the statute . . ..' Thus the claim of fraud and fiduciary breach in this complaint states a cause of action under any part of Rule 10b-5 only if… the conduct alleged can be fairly viewed as 'manipulative or deceptive' within the meaning of the statute.") *Id.* at 473.

[472] *See Id*; *Thel*, *supra* note 468, at 386.

[473] The Securities and Exchange Commission, *SEC Historical Summary of Chairmen and Commissioners,* https://www.sec.gov/about/sechistoricalsummary.htm; *Langevoort*, *supra* note 49, at 1329.

[474] *Langevoort*, *id*. *See* also Louis Loss, T*he Fiduciary Concept as Applied to Trading by Corporate "Insiders" in the United States*, The Modern Law Review, Vol. 33, No. 1, 34 (1970) (Advocating against insiders trades on the basis of inside information, Professor Loss suggested that the SEA has to develop a dominant theme in two aspects "the prevention of market manipulation and the regulation of insider trading". Professor Loss illustrated the morality reason underlying the prohibition of trading on inside information by telling a story of a female law student, which professor Loss described as having "had a healthier reaction to insider trading than her professor when she stamped her foot and declaimed "I don't care; it's just not right.") *Id*. at 35-37.

as fiduciaries. In addition, illegal corporate insider trading should be prohibited because of its inherent unfairness that would undermine investors' confidence in the integrity and honesty of the securities markets.[475] The chairman of the SEC found that state corporate law was inadequate to provide the right protection for investors. Therefore, he wanted to create a federal fiduciary responsibility law under Rule 10b-5 that would prohibit trading on the basis of inside information based on the justification of protecting investors' confidence in the securities markets.[476]

While the common law majority continued to refuse to impose fiduciary duty to disclose inside information on corporate insiders when they traded in their corporations' stock in the exchange,[477] in 1961, the SEC, through its administrative-judicial power, issued, *In the Matter of Cady, Reports& Co,* an enforcement action against a broker-dealer for trading on the basis of inside information without disclosure to the public.[478] The SEC's decision created a novel approach to prohibition of conduct or practice that was predicated

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[475] *Langevoort, Id*. at 1928; *Hines*, *supra* note 435, at 570.

[476] *See* Loss, *supra* note 50, at 44; William L. Carry et al, *Insider Trading in Stocks*, 21 Bus. Law. 1009, 1010 (1966). (William Cary suggested that: "Everyone representing management may tend to forget the underlying importance of the stockholder in the capital market. We sometimes forget that integrity in the capital markets is essential for mass capitalism.") *Id*.

[477] *Langevoort, supra* note 49, at 1321; Thomas Lee Hazen, *Corporate Insider Trading: Reawakening the Common Law*, 39 Wash. & Lee L. Rev. 845, 847 (1982). *Goodwin v. Agassiz,* 283 MASS. 358, 186 N.E. 659 (1933). The Massachusetts Supreme Court stated that directors of corporations have a duty of trust to their corporations in which they are bound to operate its business and property with good faith, but do not stand in a relation of trust to individual stockholders, and the mere silence in connection with the purchase or sale of securities in an impersonal market does not result in a breach of duty of trust. *Id*. at 358, 361. *See also*, *Carpenter V. Danforth*, 52 Barb. 581, 584 (N.Y. Sup. Ct. 1868). The Supreme Court of New York stated that directors are in a trust relation with the stockholders "only to the management of the general affairs of the corporation, with a view to dividends of profit, and therefore that the trust relation between the stockholder and director extended no further." *Id*. The court concluded that the sale of stock by a shareholder to a director is not subject to the trust relation between them requiring the director to disclose every fact known to him to the seller because there is no confidential relation between the stockholder and director. The sale of the shareholder's stock "was not the subject of trust between them, nor had the trust relation between them any connection with the shareholder's stock, except so far as the good or bad management of the general affairs of a corporation by its directors, indirectly affects the value of its stock." *Id*.

[478] Cady, Roberts & Co., Re, 40 S.E.C. 907 (1961). The writer of the opinion of the SEC its chairman, William Cary. *See Id.*at 1.

on the broad language of Rule 10b-5(c). It established that trading with nondisclosure of possessed inside information by persons having access to such information is an "act, practice or course of business' operating 'as a fraud or deceit'"[479]

The facts of this enforcement action involved a broker-dealer, Robert M. Gintel, a selling broker and a partner of Cady, Roberts &Co, who sold a large number of shares of Curtiss-Wright Company for discretionary accounts based on inside information he received from his partner and a director of Curtiss-Wright, J. Cheever Cowdin. The information received was about the company's board of directors' decision to reduce the dividends for the fourth quarter of the fiscal year of 1959. During the board of directors meeting, Cowdin informed Gintel about the upcoming reduction in dividends. However, the transformation for public disclosure by the company about the reduction was delayed for a short time because of a typing problem in their telegram. During this time, Gentel was able to sell a large number of shares for discretionary accounts before the news about the reduction of dividends was publicly disclosed.[480]

The SEC interpreted Rule 10b-5 as follows: it offers a broad remedy for fraudulent activities whether or not such activities are actionable under common law action for deceit. The SEC suggested that: "the securities acts may be aid to have generated a wholly new and far-reaching body of Federal corporation law."[481] The SEC declared that the justification of making trading on inside information illegal was is enhance the regulations to protect investors. It stated that:

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[479] *Insider Liability under Securities Exchange Act Rule 10b-5: The Cady, Roberts Doctrine*, 30 U. Chi. L. Rev. 121, 122 (1962); *See* also *Hines*, *supra* note 435, at 557-58; *Langevoort, supra* note 49, at 1319.
[480] Cady, Roberts & Co., Re, 40 S.E.C. 907, at 2 (1961). (Gintel was suspended form exchange for 20 days and fined $3,000.) *Id*.
[481] *Id*. at 3.

> So many times that citation is unnecessary, we have indicated that the purchase and sale of securities is a field in special need of regulation for the protection of investors. To this end one of the major purposes of the securities acts is the prevention of fraud, manipulation or deception in connection with securities transactions.[482]

While noting that the duty to disclose inside information was traditionally required on corporate directors, officers, and controlling shareholders, the SEC noted that these persons do not exhaust the classes of persons that the duty to disclose could be imposed upon.[483] Rule 10b-5 is phrased in terms of "any person."[484] Thus, the SEC, then, based the obligation of a duty to disclose non-public information or refrain from trading in the related security on two elements: (1) the existence of a relationship giving access to information that was intended to be available only for a corporate purposes and not for the personal benefit of anyone; and (2) the existence of inherent unfairness involved where a party takes advantage of non-public information knowing it to be unavailable to those with who the party is dealing.[485] The SEC, however, neglected to explain how these elements are derived from Rule 10b-5 since the text of Rule 10b-5 does not refer to these requisites.[486] The SEC responded by saying:

> In considering these elements under the broad language of the anti-fraud provisions we are not to be circumscribed by fine distinctions and rigid classifications. Thus our task here is to identify those persons who are in a special relationship with a company and privy to its internal affairs, and thereby suffer correlative duties in trading in its securities. Intimacy demands restraint lest the uninformed be exploited.[487]

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[482] *Id.*
[483] *Id.*at 4.
[484] *Id.*
[485]Cady, Roberts, *40 S.E.C,* at3.
[486] A.C. Pritchard, *The SEC, Administrative Usurpation, and Insider Trading*, 69 Stan. L. Rev. Online 55, 57 (2016-2017).
[487] Cady, Roberts, *40 S.E.C, at 4.* Professor Donald C. Langevoort clarified the SEC's decision by finding that: "The decision implicitly relies on the insider's duty to act affirmatively to prevent the other party's disadvantageous trade, apparently based on the duty of loyalty. In theory, had disclosure been made to the public, marketplace buyers or sellers would not have traded (at least not at that price). By so stating the duty to disclose and resulting marketplace harm, the unfair conduct could be treated as a fraud, which would satisfy the statutory prerequisite for rule 10b-5 liability." Donald C. Langevoort, *Insider Trading and the Fiduciary Principle: A Post-Chiarella Restatement*, California Law Review, Vol, 1, 6 (1982).

The SEC based its decision upon the common-law minority's opinion, which requires corporate insiders to disclose inside information in face-to-face transactions.[488] However, the SEC broadened the minority's opinion to also be applied in impersonal transactions undertaken in securities exchange markets, and upon any person who is in a special relationship with the issuer of a security.[489] The SEC described the common-law minority's opinion by stating that:

> An affirmative duty to disclose material information has been traditionally imposed on corporate 'insiders,' particularly officers, directors, or controlling stockholders. We, and the courts have consistently held that insiders must disclose material facts which are known to them by virtue of their position but which are not known to persons with whom they deal and which, if known, would affect their investment judgment. Failure to make disclosure in these circumstances constitutes a violation of the anti-fraud provisions.[490]

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[488] *Hines*, *supra* note 435, 557, 569; Cady, Roberts, *40 S.E.C,* at 3. (The SEC noted in its decision that "Although the 'majority' state rule apparently does not impose an affirmative duty of disclosure on insiders when dealing in securities, an increasing number of jurisdictions do impose this responsibility either on the theory that an insider is generally a fiduciary with respect to securities transactions or 'special facts' may make him one." Cady, Roberts & Co., Re, 40 S.E.C. 907 Nt.20 (1961). Special facts doctrine was adopted by the United States Supreme Court in *Strong v. Repide*, 213 U.S. 419 (1909). *See supra* note 447; *Speed v. Transamerica Corp*., 99 F. Supp. 808 (D. Del. 1951). ("Parent Corporation which had made written offer to all minority stockholders of subsidiary, offering to purchase their shares at fixed price without disclosure of fact that true inventory value of subsidiary was far in excess of that shown by annual report and of accompanying intent on part of parent to liquidate and thereby capture such appreciated value, had, by failure to disclose such pre-existing intent to liquidate, perpetrated fraud upon minority stockholders and must respond in damages."); *Kardon v. National Gypsum Co.,* 73 F. Supp. 798, 800 (E.D. Pa. 1947). (The defendants, who were board directors, purchased the plaintiff stock and sold the corporate asset with profit, and the plaintiff sought damages alleging that the defendants failed to disclose that they made a sale deal before purchasing the stock. The Court found that the "acts of the defendants specified in the complaint constitute a violation of the Act. Sec. 10(b)…Rule X-10B-5… Under any reasonably liberal construction, these provisions apply to directors and officers who, in purchasing the stock of the corporation from others, fail to disclose a fact coming to their knowledge by reason of their position, which would materially affect the judgment of the other party to the transaction…[T]he broad terms of the Act are to be made effective in a case like the present one through application of well known and well established equitable principles governing fiduciary relationships. These principles are fundamental in all jurisdictions and the decisions of both Pennsylvania and of Michigan fully support the conclusions reached above.") *Id.*at Nt. 13. For more discussion about the SEC development of prohibiting illegal corporate insider trading under Rule 10b-5, *see* Hugh T. Wilkinson, *The Affirmative Duty to Disclose after Chiarella and Driks*, 10 J. Corp. L. 581, 583 (1985).

[489] *See*, *Langevoort*, *supra* note 49, at 7.

[490] *Cady, Roberts*, *40 S.E.C,* at 4.

As a result, the SEC's decision interpreted Rule 10b-5 as it prevents any inherent unfair informational asymmetry between traders in second markets to maintain the protection of investors from the misuse of inside information.[491] The chairman of the SEC, William Cary, later clarified the rationale of the duty to disclose inside information adopted in the SEC's decision in *Cary, Roberts*, stating that: "insiders having access to material information available for a corporate purpose may not take advantage when it is not yet known to the public. If disclosure would be improper or unrealistic, he should forego the transaction-in other words, keep out of the market."[492]

Following the SEC's decision in *Cady, Reports,* the federal courts endorsed the SEC's opinion and provided complete support for the application of the duty to disclose or refrain from the trading doctrine.[493] The Second Circuit' decision in *SEC v. Texas Gulf Sulphur*,[494] was the first case in which a federal court found a violation of Rule 10b-5 because of trading on the basis of inside information.[495] While adopting the SEC's liberal interpretation of Rule 10b-5, the Second Circuit applied the more general prohibition

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[491] *Pritchard*, *supra* note 486, at 58. Citing Cady, Roberts, *40 S.E.C,* at 5; *Hines*, *supra* note 435, at 561 ("While the trend of the law has been a gradual ascent toward higher standards based on ethical considerations, Cady Roberts marks the highest point thus far in using the theory of complete disclosure as the principle to eliminate the dichotomy between legal rules and ethical standards.") *Id*.
[492] *Carry et al*, *supra* note 476, at 1011.
[493] *Bloomenthal & Wolff*, *supra* note 23, at §19:3.
[494] *SEC. & Texas Gulf Sulphur CO.,*401 F.2d 833 (2d Cir. 1968). (This case involved several insiders of Texas Gulf Sulphur Co., a mining company, who purchased and tipped others to purchase shares of the company on the basis of inside information related to the company's discovery of a large deposit of ore. During that time, the company released an ambiguous statement about drilling, then released a detailed statement a few days later. After the disclosure, the price of the company's stock increased substantially. The district court found some employees guilty of violating securities laws but dismissed claims of others and of the company. The Second Circuit affirmed the portion of the judgment finding certain employees liable; however, the court reversed the portion of the judgment dismissing the complaint against other employees and the company itself. The allegations against those employees and the company were remanded for further proceedings consistent with the court's opinion.) *Id*. at 843.
[495] *Bloomenthal*, *supra* note 55.

doctrine termed the "parity of information" theory.[496] The Second Circuit ruled that "all investors trading on impersonal exchanges have relatively equal access to material information."[497] The Second Circuit interpreted Rule 10b-5 based on the general intent of Congress by enacting the SEA.[498] It stated that, as a whole, enacting the SEA was to prevent unfair practices and ensure fairness in securities dealings whether conducted face-to-face, over the counter, or on exchange.[499] Drawing from this notion of fairness in securities transactions, the Second Circuit's decision disregarded the requirement of the existence of a special relationship as an element of the prohibited trading conduct that was required in the *Cady, Roberts* case.[500] The Second Circuit found that any person, a corporate insider or outsider, must not trade on or provide a tip about any possessed material non-public information unless a disclosure is made.[501]

Despite this judicial endorsement to expand the scope of fraud under Rule 10b-5 to cover unfair informational asymmetry that would undermine investors' confidence including trading on inside information, the SEC and courts failed to provide a clear standard on who is subject to the duty to disclose and who is not. This oversight led to a broad gap and uncertainty about the law of illegal corporate insider trading.[502] In addition, this theory of parity of information did not offer any justification of how illegal corporate

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[496] *Wilkinson*, *supra* note 488, at 586.

[497] *SEC. & Texas Gulf Sulphur CO.,*401 F.2d 833, 848; *Wilkinson*, at 586. For more information about the "parity of information" theory, *see Brudney*, *supra* note 10, at 339.

[498] *SEC. & Texas Gulf Sulphur CO.,*401 F.2d 833, 847.

[499] *SEC. & Texas Gulf Sulphur CO.,*401 F.2d 833, 843. *See LANGEVOORT, supra* note *6, at* §2:3.

[500] Cady, Roberts & Co., Re, 40 S.E.C. 907, at 3 (1961).

[501] *SEC. & Texas Gulf Sulphur CO.,*401 F.2d 833, 848. ("[A]nyone in possession of material inside information must either disclose it to the investing public, or, if he is disabled from disclosing it in order 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." *Id*. *See Wilkinson*, *supra* note 488, at 586.

[502] *LANGEVOORT, supra* note *6, at* §2:3.

insider trading deceives the public or how it is the cause of an economic injury to anyone. In particular, it did not clarify how trading on inside information in impersonal markets is a deceptive act by virtue of informational asymmetry between the parties because of one party's access to inside information, where there was no inducement by the violator or reliance by the other party.[503] As discussed earlier, the United States Supreme Court rejected the expansion of the scope of Rule 10b-5 to include mismanagement conducts and a breach of fiduciary duty, and found that fraud means only real deception.[504] Thus, to state that a practice is deceptive, they must show pecuniary harm because of such a practice.[505]

In 1980, the United States Supreme Court, in *Chiarella v. U.S.,*[506] had the first chance to review the preceding judicial and administrative rulings over the prohibition of illegal corporate insider trading under Rule 10b-5. Unlike earlier judicial justification for *Cady, Roberts*, the United States Supreme Court found that the idea of inherent unfairness of the informational asymmetry in illegal corporate insider trading is not a concern of Rule 10b-5. Rather, they ruled that the abuse of inside information for trading purposes through a breach of fiduciary or similar relationship of trust and confidence is a volitional conduct under Rule 10b-5.[507] In *Chiarella*, the United States Supreme Court reshaped the law of illegal corporate insider trading. They ruled that it is linked to finding a breach of duty of trust rather than basing the prohibition upon a broad notion of inherent unfairness of wrongful informational asymmetry. *Chiarella* is discussed below along with later

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[503] Donald C. Langevoort, *'Fine Distinction' in the Contemporary Law of Insider Trading*, Georgetown Public Law Research Paper No. 13-032, at 2 (2013).
[504] *See supra* note 468 and accompanying text; *Santa Fe Industries, Inc. V. Green,* 430 U.S. 462, 473; *LANGEVOORT, supra* note *6, at* §2:3; *Dooley*, *supra* note 266, at 56.
[505] *Dooley*, *id*. For more information about the elements of the common law action for deceit, *see supra* note 435 and accompanying text.
[506] *Chiarella v. United States*, 445 U.S. 222, 226 (1980).
[507] Crag W. Davis, *Misappropriators, Tippees and the Intent-to-Benefit Rule: What we Can Learn from Cady, Roberts*, 35 Seton Hall L. Rev. 263, 267 (2004).

developments of the illegal corporate insider trading law for the purpose of defining persons subject to the prohibition of trading on the basis of inside information is discussed below.

Who is Subject to Illegal Corporate Insider Trading Prohibition?

After contemplating the lack of a statutory definition of who is subject to illegal corporate insider trading prohibition under Rule 10b-5 phrased as "any person," the SEC declined to specifically define administratively who is subject to this prohibition; instead, they preferred to make the law flexible so the courts could develop it when confronting newly developed violations.[508] However, since then, the SEC has issued rules under Rule 10b-5 to clarify some legal aspects of the prohibition of illegal corporate insider trading as is developed by the case-law.[509]

The judicial development of illegal corporate insider trading is based on the "duty to disclose or abstain" doctrine recognized by the Supreme Court in *Chiarlella*.[510] It requires a finding of a non-disclosure of material non-public information in violation of a duty to speak, arising from a fiduciary or similar relationship of trust and confidence. Such a relationship is a necessary prerequisite to finding a violation of illegal corporate insider trading prohibition under Rule 10b-5. There are three judicial theories that determine who is subject to the prohibition of illegal corporate insider trading liability. The first theory is the classical theory, which prohibits traditional corporate insiders, including directors,

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[508]*Schipani* & Seyhun, *supra* note 424, at 335. Citing Jill E. Fisch, Letter to the Editor, *The Muddle of Insider Trading Regulation*, N.Y. Times (Nov. 24, 1991).
[509] *Id*. For more information about the SEC's rules in this regard, *see supra* notes 142-47 and accompanying text.
[510] This duty requires, according to *Chiarlella*, that insiders while in possession of material non-public information must disclose or abstain from trading. *Chiarella*, 445 U.S. at 26.

officers, and large shareholders from trading while in possession of material non-public information in a breach of their fiduciary duty owed to the corporation and its shareholders.[511] The second theory is the misappropriation theory, which expands the extent of the duty to disclose or abstain from trading to include certain corporate outsiders. The Supreme Court adapted this theory in *United States v. O'Hagan*.[512] The Supreme Court held that "a person commits fraud in connection with a securities transaction, and thereby violates Section 10(b) and Rule 10b-5, when he misappropriates confidential information for securities trading purposes, in breach of a duty owed to the source of the information."[513] The third theory is the tipper/tippee liability theory which includes investors termed "tippees" who receive "material nonpublic information from someone in a fiduciary relationship with the company to which that information pertains."[514] The Supreme Court held, in *Dirks v. SEC,*[515] that a tippee lacks an independent fiduciary duty to the corporations and its shareholders, in which the tippee's liability is a derivative from the insider's duty.[516]

The general understanding of these theories is that persons subject to the prohibition include any person who is entrusted with material non-public information where his/her trading on the basis of such information without disclosure would constitute a breach of their fiduciary or similar relationship of trust and confidence with the party in a transaction or to their employer or its clients. Corporate insiders, directors, officers, large shareholders are on the top of the list of persons who are subject to this prohibition. Low-level employees

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[511] *Id*. at 227; Alexander M. Short, *Insider Trading and the Presumed Circuit Split: Why Newman and Salman Are not Discordant*, 5 (2016). https://ssrn.com/abstract=2812653
[512] *U.S. v. O'Hagan*, 521 U.S. 642 (U.S.1997).
[513] *Id*. at 652-653.
[514] Black's Law Dictionary (10th ed. 2014).
[515] *Dirks v. SEC.,* 463 U.S. 646, 658 (1983).
[516] *Id*.

and private contractors such as lawyers, accountants, and underwriters are also within the status of corporate insiders. In addition, their tippees are subject to illegal corporate insider trading prohibition when the disclosure was made in breach of a fiduciary duty for personal benefit. The three theories are discussed below to further determine who is subject to the prohibition of trading on the basis of inside information.

Classical Theory

The classical theory states that corporate insiders and others who are in a fiduciary or similar relationship of trust and confidence with the shareholders of the issuer are under a duty to disclose material non-public information before they trade with the shareholders.[517] The classical theory was adopted by the United States Supreme Court in *Chiarella.*[518] In this case, the Supreme Court rejected the "parity of access to information" theory and continued its approach to narrow the scope of Rule 10b-5 to situations involving deception under common law action for deceit.[519]

Chiarella v. United States

The issue of this case was whether a person who learns from confidential documents of one corporation that it is planning an attempt to secure control of another corporation violates Section 10(b) of the SEA and Rule 10b-5, promulgated thereunder, when the person fails to disclose the impending takeover before trading in the target company's securities.[520]

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[517] Howard J. Kaplan, Joseph A. Matteo, and Alan Pfeffer. *The Law of Insider Trading*, ABA Section of Litigation 2012 Section Annual Conference April 18-20 (2012), https://goo.gl/LxkzXg.
[518] *Chiarella v. United States*., 445 U.S. 222.
[519] *Richard Painter et al., supra* note *257* at 163; *Crag W. Davis*, *supra* note 507, at 271.
[520] *Chiarella v. United States*., 445 U.S. 222, 224.

Vincent Chiarella, the petitioner, was an employee, as a markup man, of Pandick Press, a financial printer that engaged in printing takeover bids announcements.[521] During his employment term, he received five takeover bids announcements of five concealed company names. The target companies also were concealed. He could deduce the names of the target companies from other information contained in the documents, and without disclosing the information, Chiarella purchased shares in the target companies and when the takeovers were made public, he sold his shares and gained profits of approximately $30,000 over 14 months.[522] Chiarrlla was convicted in United States District Court for the Southern District of New York for criminal violations of Section 10(b) and Rule 10b-5 for intentionally misusing material non-public information in connection with the purchase and sale of securities[523]   The United States Court of Appeals, Second Circuit, affirmed the conviction. The Second Circuit supported the theory of "parity of access to information"[524] The Second Circuit ruled that "anyone—corporate insider or not—who regularly receives material nonpublic information may not use that information to trade in securities without incurring an affirmative duty to disclose."[525] Chiarella appealed before the Supreme Court against the judgment of the Second Circuit's decision.[526] The Supreme Court reversed the Second Circuit Convection and held that the duty to disclose does not arise merely from the possession of material non-public information, but it is imposed when there is a duty to speak because of being an insider or fiduciary with whom they trade. However, corporate outsiders, such as Chiarella, are not subject to such duty.[527]

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[521] *Id.*
[522] *Id.*
[523] *U.S. v. Chiarella*, 588 F.2d 1358, 1364 (1978).
[524] *Id.*at 1365.
[525] *Id.*
[526] *Chiarella v. United States*., 445 U.S. 222, 225 (1980).
[527] *Id.* at 235. *See Richard Painter et al., supra* note *257*, at 155.

The Supreme Court's decision was predicated on the idea that the duty to disclose material non-public information under Rule 10b-5 is based on the notion that Rule 10b-5 prohibits only those practices that are held to be actionable under common law action for deceit which are either an affirmative misrepresentation of material facts or silence when there is a duty to speak.[528] The Supreme Court found that trading on the basis of material non-public information constitutes silence, and to make silence fraudulent, there must be a fiduciary or another similar relation of trust and confidence between parties to a transaction in which one party is entitled to know because of this special relationship.[529] Based on this analysis, the Supreme Court held that corporate insiders always owe a fiduciary duty and they are prohibited from trading on their corporation's securities on material non-public information to personally benefit at the expense of the shareholders.[530] "Application of a duty to disclose prior to trading guarantees that corporate insiders, who have an obligation to… place the shareholder's welfare before their own, will not benefit personally through fraudulent use of material, nonpublic information."[531] The Supreme Court found that Chiarella could not be convicted on the theory of a duty to disclose to shareholders of target companies.[532] The reason was that the element that makes silence fraudulent was absent in this case. The Supreme Court held that Chiarella was not under a duty to speak because "he was not a corporate insider and he received no confidential information from the target company."[533] He also was not an agent of the sellers or a fiduciary, and "he was not a

[528] Alison Grey Anderson, *Fraud, Fiduciaries, and Insider Trading*, 10 Hofstra L. Rev. 341, 346 (1982).
[529] *Chiarella v. United States.*, 445 U.S. 222, 228; *Anderson*, at 346.
[530] *Wilkinson*, *supra* note 488, at 590.
[531] *Chiarella v. United States.*, 445 U.S. 222, 230.
[532] *Id*, at 231.
[533] *Id.*

person in whom the sellers had placed their trust and confidence. He was, in fact, a complete stranger who dealt with the sellers only through impersonal market transactions."[534]

a. The Supreme Court Rejected the "Parity of Access to Information" Theory

The Supreme Court rejected the "parity of access to information" theory that had been applied by the Second Circuit. The Supreme Court found that the Second Circuit erred in believing that "the federal securities laws have 'created a system providing equal access of information necessary for reasoned and intelligent investment decision.'"[535] In addition, the Supreme Court rejected the reasoning used by the Second Circuit in holding that the use of material non-public information by any trader in connection with securities transactions is a fraudulent act because it gives certain buyers or sellers an unfair advantage over less informed buyers and sellers. After reviewing the legislative history of Section 10(b), the Supreme Court concluded that, "neither the Congress nor the [] [the SEC] ever has adopted a parity-of-information rule."[536] The Supreme Court held that this theory had two defects:

> First not every instance of financial unfairness constitutes fraudulent activity under §10(b). Second, the element required to make silence fraudulent—a duty to disclose—is absent in this case…Formulation of such a broad duty, which departs radically from the established doctrine that duty arises from a specific relationship between two parties, should not be undertaken absent some explicit evidence of congressional intent.[537]

b. The Supreme Court Rejected to Consider the Misappropriation Theory

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[534] *Id.*at 232.
[535] *Id*.
[536] *Id.*
[537] *Id*.

The government claimed that Chiarella breached a duty owed to the acquiring corporations when he traded on information obtained through his position as an employee of a printer employed by the acquiring corporation.[538] Thus, this breach supported finding that Chiarella had committed fraud on the acquiring corporation.[539] However, the Court decided not to apply this theory because it was not submitted to the jury.[540] The Supreme Court stated that "the jury was not instructed on the nature or elements of a duty owed by petitioner to anyone other than the sellers…we cannot affirm a criminal conviction on the basis of a theory not presented to the jury."[541]

Who is an Insider under the Classical Theory?

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[538] *Id.* at 235.
[539] *Id.*
[540] *Id.* at 236.
[541] *Id*. Justice John Stevens, joined the Court's opinion that Chiarella did not owe a duty to disclose to the sellers. Id.at 237. He then answered the question of whether Chairella breached his duty of silence owed to his employers and the clients could be actionable under Rule 10b-5. Justice Stevens stated that Chiarella owed "unquestionably" a duty of silence to his employer and its customers which "could give rise to criminal liability under Rule 10b-5." *Id*. He noted that there are "respectable arguments" that Chiarella breached his duty of silence owed "to the acquiring companies that had entrusted confidential information to his employer." *Id.*at 238. However, because this theory was not presented to the jury, Justice Stevens found that "the Court wisely leaves the resolution of this issue for another day." *Id*. Justice William Brennan concurred in the judgment. *Id*. He agreed with the Court's opinion that a duty to disclose under §10(b) does not arise from the mere possession of material non-public information. However, he joined the Chief Justice's dissenting opinion that "a person violates §10(b) whenever he improperly obtains or converts to his own benefit nonpublic information which he then uses in connection with the purchase or sale of securities." Id.at 239. Then, Justice Brennan agreed with the Court that this theory of the Chief Justice was not presented to the jury. He stated that: "The simple fact is that to affirm the conviction without an adequate instruction would be tantamount to directing a verdict of guilty, and that we plainly may not do." *Id*. Chief Justice Warner Burger dissented the Court's opinion and asserted that he "would read § 10(b) and Rule 10b-5 to encompass and build on this principle: to mean a person who has misappropriated nonpublic information has an absolute duty to disclose nonpublic information or to refrain from trading." *Id.*at 240. The Chief Justice supported the view that Rule 10b-5 liability can be held against any person who trades on the basis of material non-public information that has been obtained unlawfully. Consequently, people who have acquired such information through legal practices are out of Rule 10b-5 liability. *Id*. Justice Harry Blackman, with whom Justice Thurgood Marshall joined, dissented the Court's opinion. *Id.*at 245. While agreeing with the Chief Justice's opinion that informational advantage acquired through legal means is not within the scope of lability under Rule 10b-5, Justice Blackman went further to argue that Section 10(b) and Rule 10b-5 should be read flexibly and broadly to find liability whenever a person has access to material non-public information "that the honest investor no matter how diligently he tries, could legally obtain." *Id.*247. He asserted that this is unfair dealing because the informational advantage effects the integrity of the securities dealing and investors' confidence in which the securities regulations were enacted to protect. *Id.*at 248.

In *Chiarella*, The Supreme Court did not provide an inclusive list of persons subject to the prohibition of trading on the basis of material non-public information. However, it recognized certain situations that impose a duty to disclose material non-public information.[542] The Supreme Court restricted the application of a duty to disclose under Rule 10b-5 to situations that are actionable under the common law fraud minority opinion.[543] This restriction is illustrated by the Supreme Court's reference to the two elements articulated in *Cady, Roberts,* which states that a "duty arose from (i) the existence of a relationship affording access to inside information intended to be available only for a corporate purpose, and (ii) the unfairness of allowing a corporate insider to take advantage of that information by trading without disclosure."[544] The Supreme Court found that the SEC applied the right principles because it "recognized a relationship of trust and confidence between the shareholders of a corporation and those insiders who have obtained confidential information by reason of their position with that corporation."[545] The Supreme

[542] *Wilkinson*, *supra* note 488, at 589.
[543] Langevoort, *supra* note 487, at 4; *Anderson*, *supra* note 528, at 354; Restatement (Second) of Torts § 525 (1977) ("One who fraudulently makes a misrepresentation of fact, opinion, intention, or law for the purpose of inducing another to act or to refrain from action in reliance upon it, is subject to liability to the other in deceit for pecuniary loss caused to him by his justifiable reliance upon the misrepresentation.") Professor Nagy asserted that "although an affirmative misstatement is generally required for a plaintiff to aver fraud, courts have recognized a number of circumstances under which a defendant's 'pure silence' may also constitutes fraudulent conduct. One such circumstance occurs in transactions where the defendant is under a duty to disclose material information 'because of a fiduciary or other similar relationship of trust and confidence..' indeed, the classical theory of insider trading liability is premised precisely on this exception to the general rule of caveat emptor." Donna M. Nagy, *Reframing the Misappropriation theory of Insider Trading Liability: A Post-O'Hagan Suggestion*, 59 Ohio St. L.J. 1223, 1288 (1998).
[544] *Chiarella v. United States.*, 445 U.S. 222, 227.
[545] *Hazen*, *supra* note 477, at 850 (1982). (Professor Hazen has suggested that "[t]he Court distinguished the earlier 'disclose or abstain' decision of the SEC in *Cady, Roberts* on the ground that the insider trader in *Cady, Roberts* had wrongfully obtained information from a corporate insider while in the special position of broker-dealer." *Id*. *See* also *Hines*, *supra* note 435, at 566. (Professor Hines has suggested that the decision of *Cady, Roberts* was based mostly on "the existence of an imputed corporate insider relation since the director who gave the information was also an associate of the brokerage firm…It has been traditionally held [] that persons knowingly joining with a fiduciary in a transaction constituting a breach of duty or scheme to defraud are liable to the same extent as the one who breach his fiduciary duty." *Id*.

Court also referenced the Restatement (Second) of Torts, §551 (1971).[546] This Section reads:

> (2) One party to a business transaction is under a duty to exercise reasonable care to disclose to the other before the transaction is consummated, (a) matters known to him that the other is entitled to know because of a fiduciary or other similar relation of trust and confidence between them.[547]

As a result, the Supreme Court's test to determine the persons covered under the classical theory of illegal corporate insider trading is whether a person is in a fiduciary or similar relation of trust and confidence (special relationship) with the corporation whose securities are being traded.[548] In addition, the Supreme Court stated, specifically, that the relationship between corporate insiders and the shareholders of their corporation "gives a rise to a disclosure obligation… by reason of their position with that corporation."[549]

By referencing *Cady, Roberts*' two elements, the Supreme Court determined that the concept of corporate insiders "status" is based on "the existence of a relationship affording access to inside information intended to be available only for a corporate purpose."[550] On the basis of this analysis, the status of corporate insiders includes directors,

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[546] *Chiarella v. United States.*, 445 U.S. 222, 228 (1980).
[547] Restatement (Second) of Torts § 551(2) (a) (1977). This Section also finds a duty to disclose in situations other than a fiduciary relationship with the other party as follows: "(b) matters known to him that he knows to be necessary to prevent his partial or ambiguous statement of the facts from being misleading; and (c) subsequently acquired information that he knows will make untrue or misleading a previous representation that when made was true or believed to be so; and (d) the falsity of a representation not made with the expectation that it would be acted upon, if he subsequently learns that the other is about to act in reliance upon it in a transaction with him; and (e) facts basic to the transaction, if he knows that the other is about to enter into it under a mistake as to them, and that the other, because of the relationship between them, the customs of the trade or other objective circumstances, would reasonably expect a disclosure of those facts." *Id.*§551(2)(b) to (e).
[548] *Chiarella*, 445 U.S. at 227; *LANGEVOORT, supra* note *6, at* §3:2. For more information about the determination of the existence of fiduciary duty, *see* Chapter Corporate Insider As Fiduciaries.
[549] *Chiarella*, 445 U.S. at 227.
[550] *Id.* at 227; *Langevoort*, *supra* note 487, at 20. "The insiders who will always have such an obligation are corporate directors, officers, and employees. Each of these acts in an agency…capacity, with the corporate entity itself as principal." *Id*; *Wilkinson*, *supra* note 488, at 583 Nt. 18.

officers, controlling shareholders, low-level employees, and certain outsiders "temporary-insiders" who are under a special relationship with the corporation and receive material non-public information for corporate purposes, such as lawyers, accountants, and underwriters.[551]

Corporate directors, officers, and controlling shareholders are deemed the core group of insiders covered by the classical theory due to the long and well-established common law rules that have subjected them to the duty to disclose.[552] The rationale is that directors, officers, and to some extent controlling shareholders are under a duty to disclose because they assume control over the corporation which, derivatively, provides them private access to inside information.[553] The Supreme Court, in *Chairella*, specifically named these groups by referring to *Cady, Roberts*'s rule that: "[a]n affirmative duty to disclose material information, [which] has been traditionally imposed on corporate 'insiders,' particular officers, directors, or controlling stockholders."[554] The Supreme Court justified the imposition of a duty to disclose upon these corporate insiders when they deal with the shareholders because of their key position as fiduciaries inside the corporation.[555] This is based on the notion that corporate insiders, as fiduciaries, are entrusted to consider the best interest of the corporation and its shareholders.[556] When they deal with the property of the corporation and its business opportunities, they must act solely for the goal of maximizing the corporations' profit, not their personal interests.[557] They

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[551] *Id*. *See WANG & STEINBERG, supra* note 5, at 300.
[552] *LANGEVOORT, supra* note *6, at* §3:3; *See* page 4 of this chapter.
[553] *Id*; *Brudney*, *supra* note 10, at 343.
[554] *Chiarella v. United States.*, 445 U.S. 222, 227.
[555] *Id*; *Wilkinson*, *supra* note 488, at 590.
[556] *LANGEVOORT, supra* note *6, at* §3:3.
[557] Michael Conant, *Duties of Disclosure of Corporate Insiders Who Purchase Shares*, 46 Cornell L. Rev. 53, 55 (1960).

must refrain from self-dealing and taking advantage of their position by exploiting material nonpublic information unless they disclose all material information that is unknown to the shareholders.[558]

Low-level employees, as agents of the corporation, are prohibited from misappropriating inside information to which they have access for their personal advantage.[559] The Supreme Court, in *Chairella*, referenced the Second Circuit's decision, in *SEC v. Texas Gulf Sulphur,* where some of the defendants were both officers and low-level employees of Texas Gulf Sulphur including Mollision, a mining engineer and vice president, Darke, a geologist, Holyk, chief geologist,[560] and Huntington, an attorney of Texas Gulf Sulphur.[561]

Independent contractors or "temporary-insiders" who are in a special relationship with a corporation, such as lawyers, accountants, and financial advisors, are subject to the same standard applied to corporate insiders.[562] This is because these temporary-insiders are being entrusted with access to inside information for legitimate business reasons.[563] The Supreme Court, in *Chairella*, applied this determination reasoning that Chiarella was not

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[558] *Id*; *Brudney*, *supra* note 10, 326 Nt. 22. ("[T]he obligation of the corporation and its insiders to disclose nonpublic information in dealing with security holders may be appropriately be *see*n as an extension of the arrangement protecting beneficiaries against overreaching by fiduciary, which the common law was haltingly fashioning to constrain corporate insiders when the federal securities legislation was enacted.") *Id*. *See also*, *Hazen*, *supra* note 477, at 850. ("[W]hen an insider relies on inside information in making a trade, his or her short-term investment interests are being placed in potential conflict with the corporation interest. The agent is thus put in a dual role that is traditionally forbidden.") *Id*.

[559] *LANGEVOORT, supra* note *6, at* §3:5; *WANG & STEINBERG, supra* note *5, at* 304. Citing *U.S. v. Heron*, 323 Fed. Appx. 150, 154 (2009). The Third Circuit ruled that a defendant's low level position inside a corporation "is not determinative of his insider status…'liability follows form the existence of a relationship with the corporation that makes it more probable than not that the individual has access to inside information.'.") *Id*.

[560] *SEC. & Texas Gulf Sulphur CO.,*401 F.2d 833, 843 (2d Cir. 1968).

[561] *Id.*at 855. *See LANGEVOORT, supra* note *6, at* §3:5; *WANG & STEINBERG, supra* note *5, at* 304.

[562] *LANGEVOORT, supra* note *6, at* §3:8; *WANG & STEINBERG, supra* note *5, at* 308; *Painter et al., supra* note *257*, at 154.

[563] *Id*.

subject to a duty to disclose to the shareholders of the target corporations because "[h]e was not their agent, he was not a fiduciary, [and] he was not a person in whom the sellers had placed their trust and confidence."[564] The Supreme Court also, in *Dirks v. SEC,*[565] reemphasized this determination by stating that:

> Under certain circumstances, such as where corporate information is revealed legitimately to an underwriter, accountant, lawyer, or consultant working for the corporation, these outsiders may become fiduciaries of the shareholders. The basis for recognizing this fiduciary duty is not simply that such persons acquired nonpublic corporate information, but rather that they have entered into a special confidential relationship in the conduct of the business of the enterprise and are given access to information solely for corporate purposes.[566]

<u>Misappropriation Theory</u>

<u>Introduction</u>

The misappropriation theory expands the extent of the duty to disclose or abstain from trading on the basis of material non-public information to include corporate outsiders bound by the fiduciary principle.[567] Under this theory, a person commits fraud when he/she misappropriates confidential information for securities trading purposes, in breach of fiduciary duty owed not to the persons with whom he trades, but to the source of the information.[568] "The misappropriation theory focuses not on the insider's fiduciary duty to the issuing company or its shareholders but on whether the insider breached a fiduciary duty to any lawful possessor of material non-public information."[569]

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[564] *Chiarella v. United States*, 445 U.S. 222, 231 (1980).
[565] *Dirks v. SEC.,* 463 U.S. 646,655 (1983).
[566] *Id.*at Nt. 14.
[567] Nagy, *supra* note 423, at 1330.
[568] *U.S. v. O'Hagan*, 521 U.S. 642,652 (1997).
[569] *SEC v. Cherif*, 933 F.2d 403, 409 (7th Cir. 1991); Richard J. Hunter et al, Insider Trading Since Carpenter: *The Misappropriation Theory and Beyond*, 41 Howard L.J. 79, 98 (1997-1998).

The misappropriation theory was first presented before the United States Supreme Court, in *Chairella*, where the government argued that Chiarella breached a duty of silence owed to his employer and its clients by trading on the basis of confidential information and that was a violation of Rule 10b-5.[570] However, the Supreme Court did not consider this theory because it was not submitted to the jury.[571]

The misappropriation theory was again presented before the Supreme Court in 1987, in *Carpenter v. United States.*[572] The indictment was that Foster Winans, a Wall Street reporter and one of three writers of a daily column, "Heard on the Street," along with others engaged in a scheme of fraud in which the reporter revealed prepublication information in the column.[573] They traded on the prepublication information and made a significant profit and thus benefiting from the effect of the column in the related securities prices.[574] This scheme of misusing the prepublication information was in violation of the policy of the Wall Street Journal which considered content of the column before publication the Journal's confidential information that belonged to the Journal.[575]

The District Court convicted[576] and the Second Circuit affirmed the convection of committing securities fraud, mail fraud, and wire fraud.[577] The courts concluded that

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[570] *Chiarella v. United States*, 445 U.S. 222, 235 (1980).
[571] *Id.* at 236.
[572] 484 U.S. 19 (1987).
[573] *Id.*at 22.
[574] *Id.*at 23.
[575] *Id*.
[576] *U.S. v. Winans*, 612 F.Supp. 827 (S.D.N.Y. 1985). ("Winans is said to have misappropriated a certain type of market-sensitive confidential information—the nature and timing of Wall Street Journal articles. The theft of this information is said to have operated as a fraud on the Wall Street Journal, which was in connection with the purchase and sale of securities in the featured stocks") *Id.*at 840.
[577] *U.S. v. Carpenter*, 791 F.2d 1024 (2nd Cir. 1986). ("We hold that Section 10(b) of the Securities Exchange Act and Rule 10b-5 proscribe an employee's unlawful misappropriation from his employer, a financial newspaper, of material nonpublic information in the form of the newspaper's forthcoming publication schedule, in connection with a scheme to purchase and sell securities to be analyzed or otherwise discussed in future columns in that newspaper…") *Id*.

Winans' deliberate breach of his duty of confidentiality and concealment of the scheme was a fraud and deceit against the Journal under Section 10(b) and Rule 10b-5 that constitutes misappropriation of confidential information regarding the timing and the content of the column.[578] The lower court concluded that even though the victim of the fraud was not a market participant and had no any interests in the traded securities at issue, the fraud was in connection with the purchase and sale of a security within the meaning of Section 10(b) and Rule 10b-5 because the sole purpose of engaging in the scheme was to purchase and sell securities on the basis of the timing and content of the column.[579]

On appeal before the Supreme Court, the Petitioners argued that the alleged victim of the fraud, the Wall Street Journal, had no interest in the securities traded.[580] Thus, there can be no criminal liability under Rule 10b-5.[581] The Supreme Court was evenly divided in regard to the conviction of securities fraud under Section 10(b) and Rule 10b-5.[582] Consequently, it affirmed the judgment of the lower courts.[583] The Supreme Court stated that: the Supreme Court's deadlocked decision in *Carpenter*, left the validity of the misappropriation theory unresolved.[584] Eventually, in 1997, the misappropriation theory was upheld by the Supreme Court, in *United States v. O'Hagan.*[585]

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[578] *Id*; *Carpenter v. United States,* 484 U.S. 19, 24 (1987).
[579] *Carpenter v. United States,* 484 U.S. 19, 24 (1987).
[580] *Id*.
[581] *Id.*
[582] *Id*.
[583] *Id.* (The Supreme Court states that "he Court is evenly divided with respect to the convictions under the securities laws and for that reason affirms the judgment below on those counts.") *Id*.
[584] *Painter et al., supra* note *257*, at 170. ("Because the Court issued no written opinion on the misappropriation convection, it is impossible to discern whether the justices voting against conviction under the misappropriation theory did so because they rejected the misappropriation theory entirely, or merely because they rejected its application to the particular facts presented in *Carpenter*.") *Id*. *See* also, *Hunter et al*, *supra* note 569, at 79.
[585] *U.S. v. O'Hagan*, 521 U.S. 642 (1997).

<u>United States v. O'Hagan</u>

In 1988, James Herman O'Hagan was a partner in the Dorsey & Whitney Law Firm in Minneapolis, Minnesota.[586] In that year, the law firm represented Grand Metropolitan Company, based in London, England, as a local counsel for a potential tender offer for the common stock of Pillsbury Company in Minneapolis, Minnesota, company. The law firm and its client took precautions to maintain confidence about the tender offer, and O'Hagan had no role in Grand Metropolitan representation.[587] However, during the time of Dorsey & Whitney's representation of the potential tender offer, O'Hagan bought call options and shares of Pillsbury common stock, and when Grand Metropolitan announced the tender offer to the public, O'Hagan sold his call options and common stock in Pillsbury at a profit of more than $4.3 million.[588] The U.S. government charged O'Hagan with committing mail fraud, securities fraud, and money laundering.[589] The government's indictments for violations under Section 10(b) and Rule 10b-5 were based on the misappropriation theory. The indictment was that O'Hagan breached a fiduciary duty owed to Dorsey & Whitney and its client, Grand Metropolitan, when he obtained confidential information regarding the potential tender offer, and subsequently traded on the basis of this information in the target company.[590]

The United States District Court of Minnesota convicted O'Hagan on all indictments, but he appealed to the United Stated Court of Appeals for the Eighth

[586] *Id.* at 647.
[587] *Id.*
[588] *Id.*
[589] *Id.*at 684.
[590] *U.S. v. O'Hagan*, 92 F.3d 612 (1996). The government also charged O'Hagan for trading on the basis of material non-public information related to a tender offer in violation of §14(e) of the Securities Exchange Act 1934, *15 U.S.C.A. § 78*n, and Rule 14e-3, *17 C.F.R. § 240.14e–3,* and violations of the federal mail fraud and money laundering statutes. *Id.*at 614.

Circuit.[591] The Eighth Circuit rejected to apply the misappropriation theory and reversed all of the District Court's convictions.[592] The Eighth Circuit's decision gave two justifications for their rejection of the misappropriation theory. First, this theory imposes a liability based on the mere breach of a fiduciary duty without requiring any material misrepresentation or nondisclosure as deception means according to the Supreme Court's interpretation of the language of Section 10(b).[593] Second, "it permits liability for a breach of duty owed to individuals who are unconnected to and perhaps uninterested in a securities transaction," which renders the requiring of fraud to be "in connection with the purchase or sale of any security" meaningless.[594]

In 1997, The United States appealed to the Supreme Court, and Certiorari was granted.[595] The Supreme Court reversed the Eighth Circuit's decision and held that the misappropriation theory is a valid theory under Section 10(b) and Rule 10b-5 and it "satisfies Section 10(b)'s requirement that chargeable conduct involve a 'deceptive device or contrivance' used 'in connection with' the purchase or sale of securities."[596] The Supreme Court determined that the misappropriation theory "outlaws trading on the basis of nonpublic information by a corporate 'outsider' in breach of a duty owed not to a trading

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[591] *Id.*at 614.
[592] *Id.*at 622. The Eighth Circuit held that "the misappropriation theory is not a valid basis upon which to impose criminal liability under § 10(b). Thus, because O'Hagan's convictions for securities fraud under § 10(b) and Rule 10b–5… were premised solely on the misappropriation theory, these convictions must be vacated." *Id*. For the charges under Section 14(e) and Rule 14e-3, the Eight Circuit held that: "the SEC exceeded its rulemaking authority under §14(e) when it promulgated Rule 14e-3(a) without including a requirement of a breach of a fiduciary obligation, Accordingly, we must vacate O'Hagan's securities fraud convictions under these provisions." *Id.*at 627.
[593] *Id.*at 618.
[594] *Id*. The Court concluded that: "the misappropriation theory essentially turns §10(b) on its head 'transforming it from a rule intended to govern and protect relations among market participants' into an expensive 'general fraud-on-the-source theory' which *see*mingly would apply to an infinite number of trust relationships." *Id.*at 619.
[595] *U.S. v. O'Hagan*, 521 U.S. 642 (1997).
[596] *Id.*642, 653.

party, but to the source of the information."[597] The Court stated that: "the undisclosed misappropriation of such information, in violation of a fiduciary duty...constitutes fraud akin to embezzlement…"[598]

How the Misappropriation Theory Satisfies the Requirement of Section 10(b) and Rule 10b-5

The Supreme Court determined that the misappropriation theory satisfies the requirements of conduct that is actionable under Section 10(b) and Rule 10b-5. The requirements are that the alleged conduct must be deceptive or manipulative conduct, and it is in connection with the purchase or sale of a security.

a. Trading on Misappropriated Confidential Information in Breach of a Fiduciary Duty is Deceptive Conduct.

The Supreme Court justified how the misappropriation theory satisfies the requirement of a "deceptive device" under Section 10(b). First, it established that a company's confidential information "qualifies as property to which the company has a right of exclusive use"[599] Second, it observed that deception occurs under the misappropriation theory through nondisclosure by a fiduciary who is entrusted to have access to confidential information.[600] Therefore, a fiduciary deals in deception under the misappropriation theory when he "pretends loyalty to the principal while secretly converting the principal's information for personal gain…'dupes' or defrauds the principal."[601] The Court also found that if the fiduciary discloses his plan to the principal

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[597] *Id.*
[598] *Id.*642, 654.
[599] *Id.* at 654.
[600] *Id.*
[601] *Id*. at 653.

to trade on the basis of the confidential information, "there is no 'deceptive device' and thus no Section 10(b) violation."[602]

b. Trading on Misappropriated Confidential Information in a Breach of a Fiduciary Duty is Connected to the Purchase or Sale of a Security.

The Supreme Court concluded that the misappropriation theory meets the Section 10(b) requirement that the alleged deception must be "in connection with the purchase or sale of any security." This is because the fiduciary's fraud was committed, not at the time he obtained the confidential information, but when he, without disclosure, used the confidential information to trade. "The transaction and the breach of duty thus coincide."[603] Moreover, while connecting the fraudulent conduct under the misappropriation theory with the purchase or sale of a security, the Supreme Court distinguished between the misappropriation of confidential information for securities trade purposes and embezzlement of money.[604] It limited the application of the misappropriation theory to fraudulent acts involving capitalizing on confidential information "to gain no-risk-profits" through securities transactions.[605] The Supreme Court agreed with the government that "the misappropriation theory would…not apply to a case in which a person defrauded a bank into giving him a loan or embezzled cash from another, and then used the proceeds for the misdeed to purchase securities" because the proceeds would have independent value from the subsequent use in securities transactions. Thus, "the fraud would be complete as soon

[602] *Id.* at 655.
[603] *Id.* at 656.
[604] *Id.*
[605] *Id.*

as the money was obtained." In contrast, confidential information has value "ordinarily" when it is used in securities trading.[606]

After determining the coincidence of committing fraud and trading, which connects the fraud to the purchase or sale of a security, the Supreme Court noted that the misappropriation theory serves one of the main purposes of the SEA, which is "to insure honest securities markets and thereby promote investor confidence."[607] Therefore, the Court stated that misappropriating confidential information for securities trading in a breach of a fiduciary duty owed to the source of the information harms public investors and "undermines the integrity of, and investor confidence in, the securities markets…[thus] investors likely would hesitate to venture their capital in a market where trading based on misappropriated nonpublic information unchecked by law."[608] The Court concluded that

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[606] *Id.* The Supreme Court also found that the SEC acted within its rulemaking authority under §14(e) of the SEA 1934 by promulgating Rule 14e-3. Id.at 667. The Supreme Court stated that "under § 14(e), the Commission may prohibit acts not themselves fraudulent under the common law or § 10(b), if the prohibition is 'reasonably designed to prevent … acts and practices that are fraudulent." *Id.*at 673. The Supreme Court reversed the judgment of the Eighth Circuit. Justice Antonin Scalia concurred in part and dissented in part. His disagreement was with the Court's opinion with regard to the validity of the misappropriation theory under §10(b) and Rule 10b-5. Justice Scalia pointed out that "the Court's explanation of the scope of §10(b) and Rule 10b-5…does not seem to accord with the principle of lenity we apply to criminal statutes (which cannot be mitigated here by the Rule, which is no less ambiguous than the statute)." *Id.* at 679. Justice Scalia asserted that "the unelaborated statutory language…[of] §10(b) must be construed to require the manipulation or deception of a party to a securities transaction." *Id*. Justice Clarence Thomas joined by the Chief Justice, William H. Rehnquist, concurred in the judgment in part and dissented in part. *Id.*at 680. Justice Thomas rejected the misappropriation theory because it failed to comply with the "in connection with" 10(b)'s requirement. *Id.*at 681. He stated that the Court and the SEC did not provide a coherent explanation of how the fraud committed under the misappropriation theory satisfies the "in connection with" requirement while embezzlement of money used to purchase securities lacks thereof. *Id*. Justice Thomas asserted that O'Hagan could deprive Grand of its right "to exclusive use" of the confidential information in several ways other than trading securities. *Id.*at 685. He could sell the confidential information for publication or even sell the information to the target company, and that would constitute embezzlement of Grand Met property. *Id*. Then, Justice Thomas stated that: "whether the majority's new theory has merit, we cannot possibly tell on the record before us. There are no findings regarding the 'ordinary' use of misappropriated information, much less regarding the 'ordinary' use of other forms of embezzled property… We simply do not know what would or would not be covered by such a requirement, and hence cannot evaluate whether the requirement embodies a consistent and coherent interpretation of the statute." *Id.*at 688.

[607] *Id.* at 658.

[608] *Id*.

the negative impact of the misappropriation theory upon securities markets and the congressional purpose of enacting Section 10(b) makes clear that it is not required "to hold a lawyer like O'Hagan a §10(b) violator if he works for a law firm representing the target of a tender offer, but not if he works for a law firm representing the bidder."[609]

Who is Subject to the Misappropriation Theory?

The misappropriation theory, as *O'Hagan* stated, requires a duty to disclose material non-public information before trading upon corporate outsiders who have no special relationship with the shareholders of the corporation whose securities are traded. This theory is also termed "fraud on the source of information."[610] The standard applied by *O'Hagan* was that to find a person liable under the misappropriation theory, such a person must obtain or have access to material non-public information because of a fiduciary or similar relationship of trust and confidence with the source of the information.[611] In addition, trading on the basis of this misused confidential information must occur without disclosure to the source of the information.[612] In other words, any person, while being a fiduciary to another person (the source of the information), is subject to the misappropriation theory under Rule 10b-5 if the person misappropriates confidential

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[609] *Id.*at 659. *See Nagy*, *supra* note 543, at 1276. (Professor Nagy suggested that the Supreme Court's adoption of the misappropriation theory that requires fraud on the source of the misappropriated information "allows courts to 'catch' unfairness to investors within the proscriptions of Section 10(b) and Rule 10b- 5 without the necessity of having to character the unfairness as 'fraud.'") *Id*.
[610] *Nagy*, *supra* note 131, at 1223.
[611] The Supreme Court, in *O'Hagan*, stated that: "Under the complementary 'misappropriation theory' urged by the Government here, a corporate 'outsider' violates § 10(b) and Rule 10b–5 when he misappropriates confidential information for securities trading purposes, in breach of a fiduciary duty owed to the source of the information, rather than to the persons with whom he trades." *U.S. v. O'Hagan*, 521 U.S. 642, 643 (1997).
[612] The Supreme Court asserted that "full disclosure forecloses liability under the misappropriation theory: Because the deception essential to the misappropriation theory involves feigning fidelity to the source of information, if the fiduciary discloses to the source that he plans to trade on the nonpublic information, there is no 'deceptive device' and thus no § 10(b) violation—although the fiduciary-turned-trader may remain liable under state law for breach of a duty of loyalty." *O'Hagan*, 521 U.S. 642, 655. *See Langevoort*, *supra* note 50, at 1223; Nagy, *supra* note 423, at, 1356.

information, available to the person because of the fiduciary position, for trading purposes while pretending to be loyal to the source of the information, and without disclosure of such misappropriation.[613] Therefore, the question of whether a fiduciary or similar relationship of trust and confidence exits or not is a determinative question to find a duty to disclose to the source of the information and the subsequent breach of the fiduciary duty and to find liability under the misappropriation theory.[614] However, *O'Hagan* did not clarify how to determine the establishment of fiduciary or similar relationships for the purpose of finding liability under the misappropriation theory.[615]

For the purpose of finding a duty to disclose under Rule 10b-5, the determination of the relationships as to whether they involve fiduciary or similar relationships has been developed by federal courts since *Chairella*.[616] In corporate relations, the determination was already established by the Supreme Court where, under the classical theory, corporate directors, employees, and large shareholders are deemed to be in a fiduciary relationship.[617] In addition, the Supreme Court, in *Dirks*, has recognized that persons who are under the

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[613] *Id*.
[614] *Painter et al., supra* note *257*, at 175.
[615] *Id.*at 177. *See* Rebecca S. Smith, *O'Hagan Revisited: Should A Fiduciary Duty Be Required Under the Misappropriation Theory?* 22 Ga. St. U. L. Rev. 1005, 1015 (2006). Some commentators have suggested that four main types of persons could skip liability for trading on the basis of material non-public information under this misappropriation theory adopted by the Supreme Court, in *O'Hagan*. The first group is fiduciaries who, before trading on confidential information, obtained consent of the source of the information to trade. The second group is fiduciaries who disclosed to the source of the information their intent to breach their fiduciary duty and trade based on confidential information. The third group includes persons who obtain confidential information through theft or otherwise while not being in a fiduciary relationship with the source of the information. The fourth group is persons who acquire confidential information by accident. *Smith*, at 1014; *Nagy*, *supra* note 423, at, 1350. *See infra* notes 660-83 and accompanying text.
[616] *Smith*, at 1015; *LANGEVOORT, supra* note *6, at* §6:6.
[617] *Chiarella v. United States.*, 445 U.S. 222, 227; *LANGEVOORT, supra* note *6, at* §6:6.

status of temporary insider through business relationships, such as lawyers, accountants, and financial advisors are under a fiduciary duty.[618]

The problem is that the misappropriation theory extended the scope of the duty to disclose beyond already recognized fiduciary relationships within the sphere of fiduciary-shareholder relations to also cover non-business fiduciary relationships.[619] For example, is whether a relationship between family members is a fiduciary relationship? Or is whether the contractual agreement to maintain confidentiality is a fiduciary relationship? To provide some guidance on this issue, the Second Circuit analysis in *United States v. Chestman*[620] was the most important case.[621]

The Second Circuit observed that common law has recognized that certain relationships are inherently fiduciary. These relationships include, "attorney and client, executor and heir, guardian and ward, principal and agent, trustee and trust beneficiary, and senior corporate official and shareholder."[622] Moreover, the Second Circuit noted that the misappropriation theory requires an inquiry into whether other non-traditional fiduciary relationships that are similar in characteristics to well-established fiduciary relationship can be recognized.[623] The Second Circuit asserted that "the term 'similar' implies, a 'relationship of trust and confidence' [that] must share the essential characteristics of a

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[618] *Dirks v. SEC.,* 463 U.S. 646,655 Nt (14) (1983); *United States v. Chestman*, 947 F.2d 551, 666 (2nd Cir. 1991).
[619] *Smith*, at 1015; *Chestman*, 947 F.2d at 667.
[620] *Id*. (Robert Chestman, a stock broker, received information related to the tender offer to Waldbaum, Inc., a publicly held company, from his client Keith Loeb. Keith Loeb received the information from his wife, Susan Loeb. Susan Loeb is the granddaughter of Julia Waldbaum, a member of the board of directors of Waldbaum and the wife of its founder, and the mother of Ira Waldbaum, the president and controlling shareholder of Waldbaum. *Id.*at 555. The Second Circuit reversed the convictions for violating Section 10(b) and Rule 10b-5, and affirmed the conviction for violating Rule 14e-3 by trading while in possession of material non-public information related to a tender offer.) *Id.* at 571.
[621] *Smith*, *supra* note 615, at 1016.
[622] *Chestman*, 947 F.2d at 658.
[623] *Id*.

fiduciary association."[624] The Second Circuit ruled that the essential characteristics of a fiduciary relationship are reliance, control, and dominance."[625] Therefore, the Second Circuit concluded that a similar relationship must share the same qualities as these characteristics.[626] On the basis of this analysis, the Second Circuit noted two factors that do not by themselves, create fiduciary or a similar relationship of trust and confidence. "First, a fiduciary duty cannot be imposed unilaterally by entrusting a person with confidential information…Second, marriage, [or other familial relationship] [] [do] not, without more, create a fiduciary relationship."[627] However, the Second Circuit found that "the repeated disclosure of business secrets between family members may substitute for a factual finding of dependence and influence and thereby sustain a finding of the functional equivalent of a fiduciary relationship."[628]

<u>Rule 10b5-2: The SEC's Determination on Whether a Duty of Trust or Confidence Exists.</u>

In response to many commentators urging for a federal bright-line rule determining when a similar relationship of trust and confidence exists under the misappropriation theory,[629] the SEC issued Rule 10b5-2 in 2000,[630] which reads:

> (b)…[A]"duty of trust or confidence" exists in the following circumstances, among others: (1) Whenever a person agrees to maintain information in confidence; (2) Whenever the person communicating the material nonpublic information and the person to whom it is communicated have a history, pattern, or practice of sharing

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[624] *Id.*
[625] *Id.*
[626] *Id.*at 659.
[627] *Id.*at 657-58.
[628] *Id.*at 569. For more discussion about various relationships that were found to involve fiduciary or similar relationships under the misappropriation theory, *see WANG & STEINBERG, supra* note *5, at* 432. (Enumerating eight types of relationships that at least one Court found to be fiduciary or similar relationships under the misappropriation theory: (1) Employer/employee; (2) Independent contractors; (3) Government employees; (4) journalist/employer; (5) familial relationships; (6) attorney/client; (7) partnerships; and (8) incorporated partners.) *Id.* at 432-569.
[629] *See Painter et al., supra* note *257*, at 213; *Smith*, *supra* note 615, 1020.
[630] *17 C.F.R. § 240.10b5-2*

> confidences, such that the recipient of the information knows or reasonably should know that the person communicating the material nonpublic information expects that the recipient will maintain its confidentiality; or (3) Whenever a person receives or obtains material nonpublic information from his or her spouse, parent, child, or sibling; provided, however, that the person receiving or obtaining the information may demonstrate that no duty of trust or confidence existed with respect to the information, by establishing that he or she neither knew nor reasonably should have known that the person who was the source of the information expected that the person would keep the information confidential, because of the parties' history, pattern, or practice of sharing and maintaining confidences, and because there was no agreement or understanding to maintain the confidentiality of the information.[631]

The SEC noted that the common law precedents developing similar relationships of trust and confidence under the misappropriation theory were not sufficient to protect investors' confidence and the integrity of securities markets from the improper use of confidential information for trading purposes.[632] In particular, the SEC found that *Chestman's* rule was narrow and unwarranted where the Second Circuit found that the disclosure of confidential information to a close family member or friend with the mere expectation of maintaining confidentiality is inadequate to create a fiduciary relationship.[633] The SEC noted that *Chestman's* requirements of an express agreement of confidentiality or a pre-exiting fiduciary relationship between family members and friends ignored the fact that parties who are close to family and personal relationships have a reasonable and legitimate expectation of confidentiality in their communication.[634] Therefore, the SEC issued this rule to provide a broader standard for the purpose of giving

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[631] *Id*.
[632] Selective Disclosure and Insider Trading, 64 Fed. Reg. 72590-01, 72602 (Dec. 28, 1999). For more information about the cases developing the determination of relationships of trust and confidence under the misappropriation theory, *see LANGEVOORT, supra* note *6, at* §6:7; *WANG & STEINBERG, supra* note *5, at* 432; *Smith*, *supra* note 615, at 1015.
[633] Selective Disclosure and Insider Trading, 64 Fed. Reg., at 72602.
[634] *Id*.

more clarity to the application of the misappropriation theory to non-business relationships.[635]

Paragraph (b)(1) of Rule 10b5-2 is a codification of the SEC-preferred answer of whether a mere agreement of maintaining confidentiality is enough to create a relationship of confidence actionable under the misappropriation theory.[636] Under this paragraph, the SEC does not require the agreement to be in writing or even an express agreement. By providing a soft standard of the existence agreement of confidentiality, the SEC took into consideration that, in some situations, it can be unrealistic or socially undesirable to insist that a close friend or family member should sign a confidentiality agreement or expressly agree to an oral agreement.[637]

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[635] *Id.*at 72603; *Smith*, *supra* note 615, 1020;

[636] *LANGEVOORT, supra* note *6, at* §6:7

[637] Selective Disclosure and Insider Trading, 64 Fed. Reg., at 72603. Rule 10b5-2(b)(1) is considered by commentators as an extension of the law of illegal corporate insider trading under Rule 10b-5 to include nonfiduciary parties bound by a confidentiality agreement with no expectation of loyalty. *See*, *LANGEVOORT, supra* note *6, at* §6:7; Nagy, *supra* note 423, 1361; *Smith*, *supra* note 207, at 1421. An agreement of maintaining confidentiality was ratified by many courts as a source of finding a duty of trust or confidence under the misappropriation theory. However, the agreement of confidentiality was questioned by some other courts. *See LANGEVOORT, supra* note *6, at* §6:7. The famous case in this regard was, *SEC v. Cuban,* 620 F.3d 551(2010). The Fifth Circuit questioned the validity of Rule 10b5-2(b)(1) that a duty of trust or confidence exists for the application of the misappropriation theory when a person agrees to maintain information in confidence. Mark Cuban was a large minority shareholder of Mamma.com. He received a call from the company's CEO. In that phone conversation, the CEO told Cuban that he would tell him confidential information and he wanted him to agree that he would keep the information in confidence. Cuban agreed. The CEO told Cuban that the company would have a private investment in a public equity (PIPE) offering. Cuban was upset about this news. He said, "I am screwed, I cannot sell." At a later time, Cuban sold his entire ownership in the company. *Id.*at 555. The district court dismissed the SEC's complaint under Rule 12(b)(6). *SEC v. Cuban,* 634, F.Supp.2d 713, 731 (N.D.Tex.2009). The District Court stated that a duty sufficient to support liability under the misappropriation theory can arise by agreement absent a preexisting fiduciary or similar relationship, but the agreement must consist of more than an express or implied promise merely to keep information confidential. *Id.*725. The Fifth Circuit vacated and remanded. *SEC v. Cuban,* 620 F.3d 551. The Court declined to determine whether the District Court erred in its legal analysis that the confidentiality agreement does not by itself create a duty of trust or confidence under the misappropriation theory; however, it reached a different conclusion that the District Court erred in deeming the complaint inadequate. *Id*. at 558 It held that "the allegations, taken in their entirety, provide more than a plausible basis to find that the understanding between the CEO and Cuban that was he want to trade, that it was more than a simple confidentiality agreement." *Id.*at 557. *See LANGEVOORT, supra* note *6, at* §6:7.

Rule 10b5-2(b)(2) says that a duty of trust or confidence exists when the person disclosing confidential information expects the recipient to maintain confidentiality due to history, pattern, or practice of sharing confidentiality.[638] The history, pattern, or practice of sharing confidentiality need not be related to business subjects, but rather the type of confidential matters shared in the past can demonstrate the reasonable expectation of maintaining confidentiality.[639] However, this paragraph does not describe specific relationships, but provides a circumstantial test of whether the past, pattern, or practice of the two parties would lead to a legitimate expectation of confidentiality.[640] The burden of proof of this legitimate reasonable expectation is on the government.[641]

Rule 10b5-2(b)(3) specifies close family relationships stating that whenever confidential information is obtained from a parent, spouse, child, or sibling, there is a presumption that the person obtaining the information is under a duty of trust or confidence not to trade on the basis of such information.[642] Unlike Rule 10b5-2(b)(2) where the government has the burden to prove circumstantial evidence that the disclosing person and the recipient had a history, pattern, or practice of sharing confidentiality, Rule 10b5-2(b)(3) makes a reputable presumption that the information is shared under a relationship of trust or confidence.[643] However, it provides an affirmative defense that there is no duty of trust or confidence between the trader and the disclosing close family member.[644] To prove the absence of a duty of trust or confidence, the trader must demonstrate that the disclosing

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638 Selective Disclosure and Insider Trading, 64 Fed. Reg., at 72603.
639 *Id*.
640 *Id*.
641 For more discussion about this paragraph, *see LANGEVOORT, supra* note *6, at* §6:7.
642 Selective Disclosure and Insider Trading, 64 Fed. Reg. 72590-01, 72604 (Dec. 28, 1999); *LANGEVOORT, supra* note *6, at* §6:7; *WANG & STEINBERG, supra* note *5, at* 445.
643 *LANGEVOORT, supra* note *6, at* §6:7.
644 Selective Disclosure and Insider Trading, 64 Fed. Reg., at 72604.

family member has no reasonable expectation of maintaining confidentiality because they have no (1) history, pattern, or practice of sharing confidence; or (2) there was no agreement or understanding to maintain the information in confidence.[645]

<u>Rule 14e-3: The SEC Expanded the Misappropriation Theory in a Tender Offer Context[646]</u>

After the United States Supreme Court decision in *Chairella*, which rejected the "parity of information" doctrine adopted by the Second Circuit in *SEC v. Texas Gulf Sulphur*, the SEC issued a new rule, Rule 14e-3, in 1980, under Section 14(e) of the SEA[647] to regulate illegal corporate insider trading in a tender offer context.[648] The SEC noted that

[645] *Id*; *LANGEVOORT, supra* note *6, at* §6:7; *Smith*, *supra* note 615, at 1015.
[646] A tender offer is: "[a] public offer to buy a minimum number of shares directly from a corporation's shareholders at a fixed price. [] at a substantial premium over the market price, in an effort to take control of the corporation." Black's Law Dictionary, Tender Offer (10th ed. 2014). "Other means to acquire a company include a sale of assets or a merger, [] are governed by state law primarily." MARVIN G. PICKHOLZ ET AL, SECURITIES CRIMES, § 7:30 Westlaw (database updated Nov. 2018).
[647] 15 U.S.C.A. § 78n. Section 14(e) of the Securities Exchange Act of 1934 states that: "It shall be unlawful for any person to make any untrue statement of a material fact or omit to state any material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading, or to engage in any fraudulent, deceptive, or manipulative acts or practices, in connection with any tender offer or request or invitation for tenders, or any solicitation of security holders in opposition to or in favor of any such offer, request, or invitation. The Commission shall, for the purposes of this subsection, by rules and regulations define, and prescribe means reasonably designed to prevent, such acts and practices as are fraudulent, deceptive, or manipulative." Section 14(e) which provides rulemaking authority to the SEC was added to the Securities Exchange Act, in 1970, within the William Act amendment. The William Act was concerned about regulating tender offers and conduct by the bidders and target companies. *See* Michael T. Raymond, *Validity Challenges to SEC Rule 14e-3*, 23 J. Marshall L. Rev. 308-16 (1999).
[648] This Rule was under questioning about its validity because it was argued that the SEC exceeded its authority under Section 14(e) to prohibit trading on inside information in relating to a tender offer without requiring a pre-existing fiduciary or similar relationship of trust and confidence. *Se Raymond*, *supra* note 244, at 313. *WANG & STEINBERG, supra* note *5, at* 726. However, the Supreme Court, in *O'Hagan*, affirmed Rule 14e-3. *U.S. v. O'Hagan*, 521 U.S. 642, 673 (1997). The Supreme Court concluded that the rulemaking power of the SEC "under § 14(e), [enables the SEC to] prohibit acts not themselves fraudulent under the common law or § 10(b), if the prohibition is 'reasonably designed to prevent … acts and practices that are fraudulent.'" *Id. See WANG & STEINBERG, supra* note *5, at* 733;

trading by persons in possession of material non-public information related to a tender offer results in unfair disparities in market information, prevents shareholders from making informed investment decisions, and causes market disruption.[649] Pursuant to this rule, the SEC requires any person in possession of material non-public information related to a tender offer to disclose the information and identify the source or refrain from trading until public disclosure.[650] The SEC, in civil lawsuits, and the DOJ, in criminal proceedings, use this Rule in cases that involve trading on confidential information related to a tender offer based on the misappropriation theory.[651] The main difference between persons subject to the misappropriation theory under Rule 10b-5 and others subject to Rule 14e-3 is that unlike Rule 10b-5, Rule 14e-3 does not require that the court find a violation of illegal insider trading, but must find a breach of fiduciary duty.[652] Therefore, the question of whether there is a breach of fiduciary or similar relationship of trust and confidence is irrelevant to the liability under Rule 14e-3 for trading while in possession of material non-public information in a tender offer context.[653] Rule 14e-3 reads:

> (a) If any person has taken a substantial step or steps to commence, or has commenced, a tender offer (the "offering person"), it shall constitute a fraudulent, deceptive or manipulative act or practice within the meaning of section 14(e) of the Act for any other person who is in possession of material information relating to such tender offer which information he knows or has reason to know is nonpublic and which he knows or has reason to know has been acquired directly or indirectly

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[649] SEC. EXCH. COMM'N, RELEASE NO. 6239, Tender Offers, at 5 (Sept. 4, 1980); *Raymond*, *supra* note 243, at 314.
[650] SEC. EXCH. COMM'N, RELEASE NO. 6239, *Id*.
[651] *Karmel*, *supra* note 426, at 761; Howard M. Friedman, *The Insider Trading and Securities Fraud Enforcement Act of 1988*, 68 N.C. L. Rev. 465, 472(1990).
[652] *See United States v. Chestman*, 947 F.2d 551, 571 (2nd Cir 1991). The Second Circuit reversed the conviction for violating Section 10(b) and Rule 10b-5 because of the lack of fiduciary duty or its functional equivalent. *Id*. However, it affirmed the conviction for violating Rule 14e-3 by trading while in possession of material non-public information related to a tender offer derived from the target company.) *Id.*at 563. For more information, *see LANGEVOORT, supra* note *6, at* §7:1; *WANG & STEINBERG, supra* note *5, at* 713.
[653] *Painter et al., supra* note *257*, at 167.

> from:(1) The offering person, (2) The issuer of the securities sought or to be sought by such tender offer, or (3) Any officer, director, partner or employee or any other person acting on behalf of the offering person or such issuer, to purchase or sell or cause to be purchased or sold any of such securities or any securities convertible into or exchangeable for any such securities or any option or right to obtain or to dispose of any of the foregoing securities, unless within a reasonable time prior to any purchase or sale such information and its source are publicly disclosed by press release or otherwise.[654]

Rule 14e-3 makes it unlawful to purchase or sell or cause the sale or purchase of any security of the issuer upon any person who is in possession of material non-public information related to a tender offer that was commenced by another or has taken a substantial step or steps to commence a tender offer when the possessor of the information knows or has reason to know that this information is non-public and was directly or indirectly derived from (1) the tender offeror, (2) the target company, or (3) any officer, director, partner, or employee or any other person acting on behalf of the tender offeror or the target company.[655] This rule applies to a wide range of persons whether they acquired the confidential information about the tender offer while being actual corporate insiders or as securities professionals, or others.[656] The SEC indicated that the "disclose or abstain from trading" rule imposed under Rule 14e-3 "is similar to the approach taken in Texas Gulf and Cady, Roberts." [657] However, the scope of this rule is limited as it only governs trading on material non-public information related to a tender offer.[658] Therefore, trading

[654] 17 C.F.R. §240.14e-3(a).
[655] SEC. EXCH. COMM'N, RELEASE NO. 6239, Tender Offers, at 5 (Sept. 4, 1980); *WANG & STEINBERG, supra* note *5, at* 717.
[656] *WANG & STEINBERG, supra* note *5, at* 717.
[657] *Tender Offers*, Release, *supra* note 245.
[658] *Bainbridge*, *supra* note 266, at 1196.

on material non-public information that is not related to a tender offer is still subject to liability under Rule 10b-5.[659]

<u>Recent Cases have Broadened the Scope of Illegal Corporate Insider Trading to Cover Outsiders Beyond the *O'Hagan* Scope</u>

The Supreme Court, in *O'Hagan*, has clearly stated that trading on the basis of material non-public information is prohibited under Rule 10b-5 only when there is a breach of fiduciary duty to disclose information owed to the source of the information.[660] This is because the Supreme Court analyzed illegal corporate insider trading as it involves silence or omission of material facts and silence is deceptive only when it is in a breach of fiduciary duty by the trader.[661] Therefore, the Supreme Court, in *O'Hagan*, noted that if the fiduciary told his/her principal about his/her intent to trade on material non-public information, the trading is not deceptive under Rule 10b-5 even though it is a breach of fiduciary duty actionable under State law.[662] However, some courts have been willing to go beyond the *O'Hagan* misappropriation theory and based the liability of illegal corporate insider trading upon the wrongful or improper acquisition of inside information.[663]

The traditional understanding of the reach of the misappropriation theory under *O'Hagan* was that disclosure by the fiduciary to the source of the information before trading negates liability of illegal corporate insider trading under Rule 10b-5.[664] Eventually, this understanding was tested by the First Circuit, in *SEC v. Rocklage*,[665] The court

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[659] *Id*.
[660] *U.S. v. O'Hagan*, 521 U.S. 642, 643 (1997). *See* Robert Steinbuch, *Outsider Trading: "Mere Thieves" Affirmed, S.D.N.Y. Reversed*, 37 No. 4 Securities Regulation Law Journal ART 2 (2009); *Painter et al., supra* note *257*, at 181.
[661] *Id*.
[662] *O'Hagan*, 521 U.S. at 655. *See* Nagy, *supra* note 423, at, 1344.
[663] Nagy, *supra* note 423, at, 1369.
[664] *Painter et al., supra* note *257*, at 180.
[665] 470 F.3d 1. (1st Cir. 2006).

concluded that disclosure to the principal or the source of the information about the intent of the fiduciary to trade or tip inside information does not foreclose the fiduciary from illegal corporate insider trading liability in the event of deceptive acquisition of material non-public information.[666] The facts of this case involved trading by a brother-in-law of a corporate insider on the basis of confidential information received from the insider's wife, Patricia B. Rocklage. Ms. Rocklage had an agreement with her brother that she would inform him about any confidential information received from her husband. After the insider told his wife negative information about the company, Ms. Rocklage tipped her brother about this information. However, before she tipped her brother, Ms. Rocklage told her husband that she would give her brother the information. Her brother sold his stock in the company on the next day and told another person to do the same.[667] The three defendants claimed that Ms. Rocklage's pre-tip disclosure to her husband, foreclosed them from any liability under the misappropriation theory, in accordance with *O'Hagan*.[668] The First Circuit distinguished *O'Hagan* from the facts presented in this case by finding that O'Hagan received the confidential information from his employer legitimately so the way of obtaining the information was not an issue in *O'Hagan*.[669] However, in this case, the First Circuit stated that "the SEC squarely alleges that Ms. Rocklage deceptively obtained information, and that she did so as part of a preexisting scheme to assist her brother in the sale of securities."[670] Then, the Second Circuit concluded that: "In light of her disclosure

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666 Nagy, *supra* note 423, at, 1369; *§ 4:11.Misappropriation theory—Deception*, Corp Couns Gd to Insider Trading & Rep § 4:11, Westlaw (database updated Sep. 2018).
667 *Rocklage,* 470 F.3d at 3.
668 *Id*.
669 *Id.*at 9.
670 *Id*.

to her husband, Ms. Rocklage's mechanism for 'distributing' the information to her brother may or may not have been rendered non-deceptive by her stated intention to tip. But because of the way in which Ms. Rocklage first acquired this information, her overall scheme was still deceptive."[671]

Although *O'Hagan* was understood to be excluded from liability of illegal corporate insider trading on material non-public information that was wrongfully obtained by non-fiduciaries who may have acquired the information through theft, industrial spies and other unlawful means,[672] the Second Circuit, in *S.E.C. v. Dorozhko*,[673] found corporate outsiders may be held liable for trading on stolen material non-public information through computer hacking without any pre-existing fiduciary relationship with the source of the information.[674] The case involved the defendant, Oleksandr Dorozhko, who traded on IMS Health Inc. by purchasing a "put" option before the announcement of a reduction by 28 percent of its earnings per share. After the public announcement of the unexpected earnings result, the defendant sold all his IMS options, realizing a net profit of $286,456.59.[675] The allegation by the SEC was that the defendant obtained IMS's earning reports by hacking Thomson Financial, Inc. who was hired by the IMS to provide investor relations and web-hosting services.[676] The SEC alleged that the defendant committed fraud when he hacked Thomason software which involved several misrepresentations in violation of Section

[671] *Id.*at 13-14. For more discussion about this case, *see* Nagy, *supra* note 423, at, 1344; *Misappropriation theory—Deception, supra* note 666.
[672] *U.S. v. O'Hagan*, 1997 WL 182584 (U.S.), 5 (U.S.Oral.Arg.,1997). ("QUESTION: Well, Mr. Dreeben, then if someone stole the lawyer's briefcase and discovered the information and traded on it, no violation? MR. DREEBEN: That's correct, Justice O'Connor.") *Id*. *Painter et al., supra* note *257*, at 181.
[673] 574 F.3d 42 (2nd Cir. 2009).
[674] *Steinbuch*, *supra* note 660; Nagy, *supra* note 423, at, 1370.
[675] *Dorozhko,* 574 F.3d at 44-45.
[676] *Id*.

10(b) and Rule 10b-5.[677] The SEC claimed that the defendant affirmatively misrepresented himself to gain access to material, nonpublic information, which he then used to trade.[678] The Court noted that the SEC claim was that the defendant committed simple fraud by misrepresenting himself to gain access to confidential information rather than alleging that the "defendant fraudulently remained silent in the face of a 'duty to disclose or abstain' from trading."[679] The Second Circuit also noted that the SEC allegation did not fit any of the generally accepted theories of illegal corporate insider trading.[680] However, the Second Circuit concluded that the question herein was not whether the defendant violated corporate insider trading law, but whether the defendant committed a simple fraudulent act under Section 10(b) and Rule 10b-5 by hacking Thomson's software and gaining access to confidential information.[681] The Second Circuit found that "misrepresenting one's identity in order to gain access to information that is otherwise off limits, and then stealing that information is plainly 'deceptive' within the ordinary meaning of the word."[682] However, the Second Circuit was cautious about supporting any generalization of the issue and stated that computer hacking could not be deceptive if it involved only "exploiting a weakness in an electronic code to gain unauthorized access... Accordingly, depending on how the hacker gained access, it seems to us entirely possible that computer hacking could be, by

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[677] *Id.*at 45.
[678] *Id.*at 49.
[679] *Id*.
[680] *Id.*at 45.
[681] *Id.*at 50.*See Steinbuch*, *supra* note 660.
[682] *Id.*at 51. (The Second Circuit also noted that "no precedent of the Supreme Court or the Second Circuit that forecloses or prohibits the SEC's straightforward theory of fraud.") *Id* at 49.

definition, a 'deceptive device or contrivance' that is prohibited by Section 10(b) and Rule 10b–5."[683]

Tipper/ Tippee Liability

The rationale that underlies tipper/tippee liability is that corporate insiders and other fiduciaries are not only prohibited from trading on material non-public information for their personal advantage but also are prohibited from tipping material non-public information to others to trade for the same improper purpose of taking advantage of their fiduciary position to further their personal benefit.[684] Based on this rationale, investors termed "tippees," who receive "material nonpublic information from someone in a fiduciary relationship with the company [or source] to which that information pertains,"[685] are within the zone of illegal corporate insider trading law. The theory of tipper/tippee liability was established by the Supreme Court in *Dirks.*[686] They established that tipper/tippee liability exists when (1) an insider has breached his fiduciary duty by disclosing material non-public information to a tippee in exchange for direct or indirect personal benefit; and (2) the tippee knows or should have known about the tipper's breach.[687] The Supreme Court provided objective circumstances that could infer that the tipper's disclosure was for personal benefit, such as if the disclosure was for pecuniary gain, or a reputational benefit that would translate into future earnings.[688] *Dirks* also stated that: "[t]he elements of fiduciary duty and exploitation of nonpublic information also exist when an insider makes a gift of

[683] *Id*. for more discussion about this case, *see Steinbuch*, *supra* note 660; Nagy, *supra* note 423, at 1370; James A. Jones II, *Outsider Hacking and Insider Trading: The Expansion of Liability Absent A Fiduciary Duty*, 6 Wash. J.L. Tech. & Arts 111 (2010).
[684] *Dirks v. SEC.,* 463 U.S. 659 (1983).
[685] Black's Law Dictionary (10th ed. 2014).
[686] 463 U.S. 646 (1983).
[687] *Id.*at 660
[688] *Id.*at 663.

confidential information to a trading relative or friend."[689] Recently, the Supreme Court, in *Salman v. U.S.*,[690] revisited the tipper/tippee liability issue in a narrow decision regarding whether a tip to a relative by itself constitutes a personal benefit in the form of a gift from the tipper to the tippee or if it is required that the tipper receives something of tangible value in exchange for the tip.[691] The following discussion describes the two Supreme Court decisions followed by analysis of the standard of tipper/tippee liability.

<u>Dirks v. S.E.C.</u>

On March 7, 1973, when Raymond Dirks was serving as an officer of a broker dealer who specialized in providing investment analysis of an insurance company security for institutional investors, he received information from Ronald Secrist, a former officer of the insurance company (the Equity Funding Corporation of America), listed on the New York Stock Exchange. The information indicated that the company was involved in fraudulent security practices by vastly overstating its assets.[692] The former officer added that the Securities Exchange Commission had failed to act upon previous complaints made by some employees of the company.[693] Eventually, Dirks decided to launch his own investigation about the alleged fraud scheme and successfully determined that certain company employees corroborated the fraud charges.[694] However, senior management denied any wrongdoing.[695] Neither Dirks nor his firm owned any of the company's stock, but during Dirks' investigation, he discussed and disseminated the information he obtained

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[689] *Id.*at 664.
[690] 137 S. Ct. 420 (2016).
[691] *Id.*at 423. *See LANGEVOORT, supra* note *6, at* §4:6.
[692] *Dirks v. SEC.,* 463 U.S. at 648-49
[693] *Id.* at 649.
[694] *Id.*
[695] *Id.*

from the former officer to various clients and investors.[696] Consequently, some of them sold their securities in the company.[697] After the price of the Equity Funding's stock fell during Dirks' investigation, the New York Stock Exchange halted trading in the stock and state insurance authorities impounded the company's records and uncovered evidence of fraud.[698] After a hearing by an administrative law judge, the SEC found that Dirks had aided and abetted violations of the antifraud provisions of the federal securities laws, including Section 10(b) and Rule 10b-5 by repeating the allegation of fraud to members of the investment community who later sold their stock in the company.[699] The SEC concluded that when tippees, disregarding their position or motivation, come into possession of material non-public information that they know is confidential information and know or should know came from a corporate insider, they must publicly disclose the information or abstain from trading until public disclosure.[700] The SEC only censured Dirks due to his role of disclosing the fraud allegation to several investors.[701]

Dirks sought a review in the United States Court of Appeals for the District of Columbia Circuit.[702] The D.C. Circuit entered a judgment against Dirks for the reasons

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[696] *Id*.
[697] *Id*.
[698] *Id.*at 650.
[699] *Id*.
[700] *Id.*at 650-51.
[701] *Id.*at 651-52.
[702] *Dirks v. S.E.C.*, 681 F.2d 824 (D.C. Cir. 1982). *See Whistle Blowing as a Rule 10b-5 Violation: Dirks v. SEC*, 36 U. Miami L. Rev. 987 (1982).

presented by the SEC.[703] Eventually, Dirks appeared before the Supreme Court which granted Dirks a writ of certiorari to seek a review of the decision of the D.C. Circuit.[704] The issue that the Supreme Court reviewed was whether Dirks violated the antifraud provisions of the federal securities laws by his disclosure of material non-public information.[705] The court established its review of the case by citing its ruling in *Chiarella* where it stated:

> A duty to disclose or abstain does not arise from the mere possession of nonpublic market information. Such a duty arises rather from the existence of a fiduciary relationship… There must also be manipulation or deception to bring a breach of fiduciary duty in connection with a securities transaction within the ambit of Rule 10b–5. Thus, an insider is liable under the Rule for inside trading only where he fails to disclose material nonpublic information before trading on it and thus makes secret profits."[706]

After review, the Supreme Court reversed the D.C. Circuit[707] and rejected the SEC's position that a tippee who merely and knowingly receives material non-public information from an insider is under a fiduciary obligation to disclose before trading.[708] SEC's position, as the Supreme Court explained, runs contrary to the Supreme Court's holding in *Chiarella,*[709] where it stated that a duty to disclose arises from the relationship between parties and not merely from one's ability to receive information due to his position

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[703] *Dirks v. S.E.C.*, 681 F.2d 824. (The United States Court of Appeals for the District of Columbia Circuit affirmed that "Dirks had a duty to disclose what he knew about Equity Funding to the public or to refrain from trading (or fostering trades) in Equity Funding securities. He violated that duty, and with it Rule 10b-5, when he passed his information to investors who were likely to sell their Equity Funding securities before the public learned about the Equity Funding fraud." *Id.*at 837. The Court based its decision on that "the obligations of corporate fiduciaries pass to all those to whom they disclose their information before it has been disseminated to the public at large. Thus Dirks (and through him his clients) became subject to his informants' disclose-or-refrain obligation." *Id*. at 839. *See Whistle Blowing as a Rule 10b-5 Violation: Dirks v. SEC*, *id*. at 990.
[704] *Dirks v. SEC.,* 463 U.S. 646, 652 (1983).
[705] *Id.* at 648.
[706] *Id*. at 647.
[707] *Id.*at 667.
[708] *Id.*at 655-56.
[709] *Id*.

in the market.[710] Therefore, the Court concluded that a tippee lacks an independent fiduciary duty to both the corporation and its shareholders,[711] but a tippee has a duty to disclose or abstain in a derivative obligation from the insider's duty.[712] As a result, a tippee assumes a fiduciary duty not to trade on material non-public information only when the tipper has breached his fiduciary duty by disclosing the information to the tippee and the tippee knows or should have known that there was a breach.[713]

The Supreme Court concluded that Dirks did not violate illegal corporate insider trading and tipping rules.[714] The Court reasoned that Dirks himself had no pre-existing fiduciary duty to the corporation's shareholders.[715] In addition, it is clear that the tippers did not violate their duty to disclose or abstain from trading to the corporation's shareholders by providing information to Dirks because of no personal benefit was gained from the disclosure.[716] The lack of personal benefit is illustrated by the fact that the tippers received no monetary or personal benefit from revealing the corporation's fraudulent activities, nor was their purpose to make a gift of valuable information to Dirks.[717] In fact, the tipper's motivation for the disclosure was to expose the fraud.[718] As a result, the Court concluded that because the tipper did not breach his fiduciary duty by the disclosure, there was no derivative fiduciary duty on Dirks. Therefore, Dirks breached no duty when he

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[710] *Id.*at 657-58.
[711] *Id.*at 655.
[712] *Id.*at 659.
[713] *Id.*at 660.
[714] *Id.*at 665.
[715] *Id*.
[716] *Id.*at 666.
[717] *Id.*at 667.
[718] *Id*.

passed the information to others who subsequently traded on this information.[719] The Court reversed the judgment of the Court of Appeals.[720]

The Supreme Court was cautious about a general prohibition on tipper/tippee liability as it realized that not every disclosure constitutes a breach of fiduciary duty.[721] In addition, it realized that the imposition of a general prohibition of trading on material non-public information knowingly received from an insider "could have an inhibiting influence on the role of market analysts, which the SEC recognizes is necessary to the preservation of a healthy market."[722]

The Supreme Court noted that a typical scenario about whether the disclosure was in breach of duty to disclose is when insiders disclose material non-public information to analysts.[723] The Court stated that this disclosure can be in breach of the insider duty to disclose or abstain from trading based on the circumstances.[724] This is because it may be unclear whether "[c]orporate officials may mistakenly think the information already has been disclosed or it is not material enough to effect the market."[725] In addition, the insider may sometime disclose material non-public information without a breach of his/her

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[719] *Id*.
[720] *Id*.
[721] *Id.*at 662.
[722] *Id.*658-59. (The Supreme Court noted that it "is commonplace for analysts to 'ferret out and analyze information,' and this often is done by meeting with and questioning corporate officers and others who are insiders. And information that the analysts obtain normally may be the basis for judgments as to the market worth of a corporation's securities. The analyst's judgment in this respect is made available in market letters or otherwise to clients of the firm. It is the nature of this type of information, and indeed of the markets themselves, that such information cannot be made simultaneously available to all of the corporation's stockholders or the public generally.") *Id*. For more discussion about the policy reasons underlying the Supreme Court's decision, *see* Adam C. Pritchard, *Dirks and the Genesis of Personal Benefit*, 68 S.M.U.L. Rev 857, 859 (2015).
[723] *Id.*at 662.
[724] *Id*.
[725] *Id*.

fiduciary duty.[726] On the basis of this understanding of the varying legal status scenarios of disclosure of material non-public information, the Supreme Court concluded that the determination of whether the disclosure was in breach of the insider's duty to disclose or abstain from trading depends on the purpose of the disclosure.[727]

The Supreme Court stated that since the SEC's opinion was that the purpose of securities laws was to eliminate the use of material non-public information for personal advantage. Thus, the test herein "is whether the insider personally will benefit, directly or indirectly, from his disclosure. Absent some personal gain there has been no breach of duty to stockholders. And a absent a breach by the insider, there is no derivative breach."[728] The Supreme Court, however, noted that that determination of whether a tipper benefits from a disclosure is a question of fact and it would not be easy for courts to exclusively determine the circumstances under which such a benefit may be received.[729] Therefore, the court provided objective criteria to define whether the tipper obtained a direct or indirect personal benefit from the disclosure as follows:

- A pecuniary gain
- A reputational benefit that will translate into future earnings
- A relationship between the tipper and the tippee that suggests a *quid pro que* from the latter
- An intention to benefit the particular recipient

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[726] *Id.*
[727] *Id.*
[728] *Id.*
[729] *Id* at 664.

- When an insider makes a gift of confidential information to a trading relative or friend. The tip and trade resemble trading by the insider himself followed by a gift of the profits to the recipient.[730]

These objective circumstances can be reduced to three possible situations that a personal benefit could be gained by the tipper from the disclosure: a reciprocal exchange for pecuniary gain, a reputational benefit that will translate into future earnings, or a gift to a relative or a friend.[731] The major issue that has been under judicial scrutiny among these objective circumstances is the gift scenario of which the disclosure is made as a gift to a relative or friend.[732] This issue resulted in a contradictory interpretation of *Dirks*' personal benefit test between the Second Circuit[733] and the Ninth Circuit[734] and eventually went to the Supreme Court in January 2016, to resolve this issue.[735]

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[730] *Id. See*, Jill E. Fisch, *Family Ties: Salman and the Scope of Insider Trading*, Faculty Scholarship Paper 1679, 46-50 (2016). The Supreme Court's decision, in *Dirks*, was dissented by Justice Harry Blackmun with whom Justice William Brennan, and Thurgood Marshall joined. Justice Blackmun rejected the personal benefit test created by the Court as it added a new requirement to the fiduciary duty doctrine. *Dirks v. SEC.,* 463 U.S. 646, 667. "This innovation excuses a knowing and intentional violation of an insider's duty to shareholders if the insider does not act from a motive of personal gain." *Id.*at 668. Justice Blackmun argued that the Court's innovation of personal motivation is not justified even on the facts of this case. "Secrist could not do by proxy what he was prohibited from doing personally. But this is precisely what Secrist did. Secrist used Dirks to disseminate information to Dirks' clients, who in turn dumped stock on unknowing purchasers. Secrist thus intended Dirks to injure the purchasers of Equity Funding securities to whom Secrist had a duty to disclose. Accepting the Court's view of tippee liability, it appears that Dirks' knowledge of this breach makes him liable as a participant in the breach after the fact." *Id.*at 671. Justice Blackmun opposed the creation of the personal benefit test because "[i]t makes no difference to the shareholder whether the corporate insider gained or intended to gain personally from the transaction; the shareholder still has lost because of the insider's misuse of nonpublic information. The duty is addressed not to the insider's motives, but to his actions and their consequences on the shareholder. Personal gain is not an element of the breach of this duty." *Id.*673-74.

[731] *Fisch*, *supra* note 730, at 50.

[732] *WANG & STEINBERG, supra* note *5, at* 390.

[733] *United States v. Newman*, 773 F.3d 438 (2nd Cir. 2014)

[734] *U.S. v. Salman*, 792 F.3d 1087 (9th Cir. 2015).

[735] *Salman v. U.S.*, 137 S. CT. 420 (U.S. 2016). For more discussion about the apparent split between *Newman* and *Salman*, *see* Ronald J. Colombo, *Tipping the Scales against Insider Trading: Adopting a Presumption of Personal Benefit to Clarify Dirks*, Forthcoming, 45 Hofstra L. Rev. 117 (2016); Short, *supra* note 511, at 5; *Seaforth*, *supra* note 424*,* 175; *Pritchard*, *supra* note 722; Donna M. Nagy, *beyond Dirks: Gratuitous Tipping and Insider Trading*, 42 J. Corp. L. 1 (2016); Katherine Drummonds, *Resuscitating Dirks: how the Salman Gift Theory of Tipper-Tippee personal Benefit Would Improve Insider Trading Law*, 53 Am. Crim. L. Rev. 833 (2016).

Salman v. United States

The split between the Second and Ninth Circuits prompted the United States Supreme Court to grant a writ of certiorari in January 2016, to review whether an insider's gift of material non-public information to a trading relative or friend is not enough to establish securities fraud unless the tipper's goal of the disclosure is to obtain money, property or something of tangible value.[736] The assumed judicial spilt between the Second and Ninth Circuits was imputed to the decision of the Second Circuit, in *Newman,* as it created an additional requirement that the government needed to prove that the disclosure was made as a gift to a relative or friend. The government must prove "a meaningfully close relationship" between the tipper and tippee "that generates an exchange that is objective, consequential, and represents at least a potential gain of tangible value."[737] In contrast, the Ninth Circuit, in *Salman*, found that no further proof is required from the government to show that the tipper received a personal benefit by disclosing material non-public information as a gift to a relative or friend.[738]

The facts of *Salman* as presented in the Supreme Court's decision was as follows: Maher Kara, worked as an investment banker in Citigroup's healthcare investment banking

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[736] *Salman v. U.S*., 137 S. Ct. 420, 425 (U.S. 2016).
[737] *U.S. v. Newman*, 773 F.3d 438, 452 (2nd Cir. 2014). (The fact of this case involved two defendants, Todd Newman and Anthony Chiasson, who were analysts and portfolio managers at different firms. The allegation was that they traded on the basis of material non-public information regarding earnings information about two corporations, Dell and NIVDIA. *Id.*at 443. The allegation showed that the defendants were remote tippees and were three and four levels removed from the original insider tipper. *Id*. The issue the Second Circuit reviewed was whether the District Court's instruction to the jury misled or inadequately informed them about the applicable law when it refused to instruct the jury to find whether Newman and Chiasson knew the corporate insiders had disclosed confidential information for personal benefit in order to find them guilty. *Id.*at 444-45. The Court agreed and held that "the district court was required to instruct the jury that the government had to prove beyond a reasonable doubt that Newman and Chiasson knew that the tippers received a personal benefit for their disclosure.") *Id.* at 450-51.
[738] *Salman*, 792 F.3d, 1087, 1094 (9th Cir. 2015). *See LANGEVOORT, supra* note *6, at* §4:6. *See* also *supra* note 741.

group.[739] Maher tipped his older brother, Mounir Kara (Michael), confidential information about upcoming mergers and acquisitions of and by clients of Citigroup.[740] Michael then traded on this information and passed the information to Yacoub Salman, Michael's friend and Maher's future brother-in-law, who made over $1.5 million in profit.[741] The evidence established that Maher and Michael enjoyed a very close relationship.[742] Michael was like "a second father to Maher" including paying his college tuition. [743] Michael was also the best man at Maher's wedding to Salman's sister.[744] Furthermore, Maher testified that he leaked material non-public information to his brother with the intent of benefiting him and he expected that his brother would trade on it.[745] Maher also said that he tipped his brother to "help him and to fulfill whatever needs he had."[746] Michael testified that after he and Salman became friends, he began to tip Salman confidential information at any time a major deal came in.[747] Finally, Salman was aware that the information was coming from Maher and Michael testified that he informed Salman that the information was coming from Maher.[748] The Ninth Circuit affirmed the conviction finding that Salman's awareness that Maher was the source of the information was sufficient to demonstrate that Salman knew that Maher intended to benefit Michael by tipping him material non-public

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739 *Salman v. U.S.*, 137 S. Ct. 420, 424 (U.S. 2016).
740 *Id*.
741 *Id*.
742 *Id*.
743 *Id*.
744 *Id*.
745 *Id*.
746 *Id*.
747 *Id.*at 425.
748 *Id*.

information as a gift of confidential information to a trading relative, which is precisely what *Dirks* constructed.[749]

In January 2016, the United Stated Supreme Court granted Salman a writ of certiorari to resolve this issue. Salman argued before the Supreme Court that "a tipper does not personally benefit unless the tipper's goal in disclosing inside information is to obtain money, property, or something of tangible value."[750] He also argued that defining a gift as a personal benefit makes the insider-trading offense uncertain and vastly general.[751] First, it may make the offense indeterminate because it does not specify the closeness of the relationship between the tipper and tippee and the tipper's purpose for the disclosure.[752] Second, determining that a gift is a personal benefit is an overly broad standard because the government would be released from proving a specific personal benefit by simply arguing that the tipper intended to disclose the information as a gift to the tippee.[753] Furthermore, Salman asserted that the gift standard generates problems for remote tippees who were unaware of the relationship between the tipper and first tippee. Thus, they may not know the tipper's purpose of the disclosure.[754] In contrast, the government argued that a gift of material non-public information to any person, not just a trading relative or friend, is solely enough to demonstrate securities fraud.[755] According to the government's argument, a tipper would personally benefits whenever he disclosed material non-public information for non-corporate purposes.[756] Therefore, the mere tipping of such information

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[749] *U.S. v. Salman*, 792 F.3d, 1087, 1094 (9th Cir. 2015). *See Pritchard*, *supra* note 722, at 858.
[750] *Salman v. U.S.*, 137 S. Ct. 420, 426 (U.S. 2016).
[751] *Id*.
[752] *Id*.
[753] *Id*.
[754] *Id*.
[755] *Id*.
[756] *Id*.

as a gift to a relative, a friend, or any other person infers that the tipper has exploited the trading value of the information for personal purposes and thus personally benefited from the disclosure.[757] Moreover, the government asserted that the concern about indeterminate criminal liability for remote tippees is mostly alleviated by other statutory elements. The government explained that to establish a tipper liability in a criminal offense, it must demonstrate beyond a reasonable doubt that the tipper expected that the information he disclosed would be used in securities trading. In addition, the government must prove that the tippee knew that the tipper's purpose of disclosing such information was for a personal benefit in which the tipper expected the recipient to use this information to trade.[758]

The Supreme Court started its analysis of *Salman* by adhering to its decision in *Dirks* where the Court asserted that: "We adhere to Dirks, which easily resolves the narrow issue presented here."[759] The Court reemphasized that disclosure of confidential information without personal benefit is not enough to find liability.[760] The Court also asserted that the standard to infer gaining a personal benefit is based on objective criteria as it articulated in *Dirks*.[761] "whether the insider receives a direct or indirect personal benefit from the disclosure, such as a pecuniary gain or a reputational benefit that will translate into future earnings.[762] The Court reemphasized that "the elements of fiduciary duty and exploitation of nonpublic information also exist when an insider makes a gift of confidential information to a trading relative or friend."[763] The Court illustrated this type

[757] *Id*.
[758] *Id.*at 427.
[759] *Id*.
[760] *Id*.
[761] *Id*.
[762] *Id*.
[763] *Id*.

of personal benefit as "the tip and trade resemble trading by the insider followed by a gift of the profit to the recipient."[764]

The Supreme Court unanimously affirmed the Ninth Circuit's conviction, finding that Maher, the tipper, tipped confidential information to a close relative, Michael. *Dirks* made it clear that a tipper breaches a fiduciary duty by making a gift of confidential information to a trading relative.[765] The Supreme Court stated that *Dirks*, specifically, found that when an insider tips confidential information to a trading relative or friend, "the jury can infer that the tipper meant to provide the equivalent of a cash gift."[766] Thus, "the tipper benefits personally because giving a gift of trading information is the same thing as trading by the tipper followed by a gift of the proceeds."[767] The Court concluded that when Maher disclosed material non-public information as a gift to his brother with the awareness that he would trade based on this information, he breached his duty of trust and confidence to Citigroup and its clients.[768] Salman, in turn, breached this inherited duty for himself by trading on it when he knew that this information had been improperly disclosed.[769] In addition, the Supreme Court rejected part of the Second Circuit's holding in *Newman* that the tipper must obtain something of a "pecuniary or similarly valuable nature in exchange for a gift to family or friends."[770] Thus, the Supreme Court described the *Newman* requirement as inconsistent with its decision in *Dirks*.[771]

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[764] *Id*.
[765] *Id*.
[766] *Id.*at 428.
[767] *Id*.
[768] *Id*.
[769] *Salman v. U.S.*, 137 S. Ct. 420, 428-429.
[770] *Id*. Citing *Newman*, 773 F.3d, at 452.
[771] *Salman v. U.S.*, 137 S. CT. 420, 428.

Finally, the Supreme Court acknowledged that demonstrating whether an insider personally benefits from a disclosure is a question of fact and is not always easy for courts.[772] However, the Court stated that "there is no need for us to address those difficult cases today, because this case involves 'precisely the 'gift of confidential information to a trading relative' that *Dirks* envisioned."[773]

<u>Tipper/Tippee Liability Standard</u>

Before discussing the standard of tipper/tippee liability, it is worth mentioning some basic points that underlie the purpose of establishing the standard of tipper/tippee liability and whether this standard is also applied under the misappropriation theory. In *Dirks*, the Supreme Court rejected the SEC's argument that any person in possession of material non-public information received from an insider is under a duty to disclose or abstain from trading under Rule 10b-5.[774] However, the Court asserted that tippees may assume fiduciary duty to the shareholders when they receive material non-public information from an insider. The Court reasoned that since insiders are prohibited from trading on confidential information for their personal benefit, they are also prohibited from tipping others information for the same propose.[775] Therefore, tippees' duty to disclose or abstain from trading under Rule 10b-5 is derived or inherited from the insider's duty owed to the shareholders.[776] The Supreme Court also noted that not every disclosure constitutes a breach of fiduciary duty, such as if the disclosure was made mistakenly and whether the

[772] *Id*.
[773] *Id*.
[774] *Dirks v. SEC.,* 463 U.S. 646, 657-58 (1983). *See Colombo*, *supra* note 735, at 126; *Pritchard*, *supra* note 722, at 859.
[775] *Dirks,* 463 U.S. at 659-60.
[776] *Id*.

information disclosed was material or non-public.[777] Thus, the Supreme Court created an objective standard that any disclosure that will derive fiduciary duty to the tippee not to trade is based on whether the tipper's purpose of the disclosure was to receive direct or indirect personal benefit from the disclosure.[778] The Supreme Court's reasoning for the adoption of this objective rule was that the SEC and courts are not required to read the parties minds and because one of the purposes of securities law is to prevent exploitation of inside information for personal advantage.[779]

Before *Salman*, the lower courts disagreed on whether *Dirks'* approach applies in its entirety under the misappropriation theory.[780] However, the Supreme Court, in *Salman*, assumed that tipper-tippee liability may also be found under the misappropriation theory.[781] While the tipper-tippee insider trading liability under the classical theory involves a tipper's breach of fiduciary duty owed to the shareholders of the corporation, the misappropriation theory involves a tipper's breach of fiduciary duty owed to the source of the information.[782] The Supreme Court mostly based this assumption, in most part, on the government's acknowledgment that "*Dirks*'s personal-benefit analysis applies in both classical and misappropriation cases."[783]

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[777] *Id*. at 662. ("In some situations, the insider will act consistently with his fiduciary duty to shareholders, and yet release of the information may affect the market. For example, it may not be clear—either to the corporate insider or to the recipient analyst—whether the information will be viewed as material nonpublic information. Corporate officials may mistakenly think the information already has been disclosed or that it is not material enough to affect the market.") *Id*.
[778] *Id*.
[779] *Id.*at 662-63. *See Dirks v. SEC: The Supreme Court Established the Standard for Tippee Liability Under Rule 10B-5*, 36 Baylor L. Rev. 217, 230 (1984); *Pritchard*, *supra* note 486, at 860.
[780] *LANGEVOORT, supra* note *6, at* §6:13. *See Seaforth*, *supra* note 424, at 187.
[781] *Salman v. U.S.*, 137 S. Ct. 420, Nt. 2 (U.S. 2016).
[782] *Colombo*, *supra* note 735, at 126; *LANGEVOORT, supra* note *6, at* §6:13.
[783] *Salman v. U.S.*, 137 S. Ct., at 420 Nt. 2.

Dirks' standard of tipper/tippee liability is that the tippee may be found liable whenever the tip is in breach of the tipper's fiduciary duty upon which the purpose of the breach is to receive direct or indirect personal benefit from the disclosure, and the tippee "knows or should know" about the breach. [784]

Personal Benefit Test

A personal benefit received from the disclosure can be inferred from objective criteria established in *Dirks*,[785] where the tipper receives economic or personal benefit.[786] The objective criteria established in *Dirks*, can be narrowed down to three types of personal benefit.[787] First, pecuniary gain[788] is the easiest type to infer the receiving of personal benefit where the tipper economically profits in an intangible way from the tippee's trade.[789] This can occur, for instance, through a pre-arranged agreement between the tipper and the tippee to share the profits of the trade.[790] Second, a reputational benefit that will translate into future earnings[791] is received by the tipper not at the time of the tip but the tipper hopes the disclosure will help him/her receive something of value in the future.[792] For example, a CEO of a corporation may tip a security analysist confidential information with the hope that the security analysist will say some good things about the CEO in the future.[793] The third type of personal benefit is the disclosure in the form of a gift to a relative

[784] BRENT A. OLSON, PUBLICLY TRADED CORPORATIONS HANDBOOK, §17:25, Westlaw (database updated Oct. 2018); HAZEN*, supra* note 2, at §12:167.
[785] *Dirks v. SEC.,* 463 U.S. 646, 663-64 (1983).
[786] *Id*. *See* Hazen, *supra* note 9, at §12:167.
[787] *LANGEVOORT, supra* note *6, at* §4:6.
[788] *Dirks,* 463 U.S. at 663-64.
[789] *LANGEVOORT, supra* note *6, at* §4:6.
[790] *Id*; PICKHOLZ ET AL, *supra* note 646, at §7:27.
[791] *Dirks,* 463 U.S. at 663-64.
[792] *LANGEVOORT, supra* note *6, at* §4:6.
[793] *Id*.

or friend.[794] Lower Courts have been flexible with the personal benefit and applied it broadly instead of strictly.[795] In addition, the SEC assumes that the mere fact of a friendship relationship between the tipper and the tippee is enough to infer that the disclosure was for personal benefit.[796] However, in 2014, the Second Circuit, in *Newman v. United Statas*, decided to strictly read *Dirks* personal benefit test and refused to accept that the fact of a mere friendship satisfies *Dirks* personal benefit test.[797] The Second Circuit reasoned that accepting the mere fact of friendship of a casual or social nature to infer a personal gain would make the personal benefit requirement a nullity.[798] Therefore, the Court held that "such an inference is impermissible in the absence of proof of a meaningfully close personal relationship that generates an exchange that is objective, consequential, and represents at least a potential gain of a pecuniary or similarly valuable nature."[799] However, the Supreme Court, in *Salman*, rejected the Second Circuit's holding that the tipper must obtain something of a "pecuniary or similarly valuable nature," because, as the Supreme Court claimed that it is inconsistent with *Dirks*.[800] The Supreme Court's core analysis was that the tip by itself to a relative or friend is the equivalent of the tipper trading and giving the proceeds as a gift to a relative or friend.[801] Nevertheless, the Supreme Court did not expressly overturn the other part of *Newman's* holding that the government must prove a

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[794] *Dirks,* 463 U.S. at 664. *See Id*; *Colombo*, *supra* note 735, at 134. *Drummonds*, *supra* note 735, at 841.
[795] HAZEN, *supra* note 2, at §12:167; *Seaforth*, *supra* note 424, at 187.
[796] HAZEN*, id.*
[797] PICKHOLZ ET AL, *supra* note 646, at §7:27.
[798] *U.S. v. Newman*, 773 F.3d 438, 452 (2ND CIR. 2014).
[799] *Id.*at 452-53. (The court held that to hold a tippee liable, the government must prove beyond a reasonable doubt: "that (1) the corporate insider was entrusted with a fiduciary duty; (2) the corporate insider breached his fiduciary duty by (a) disclosing confidential information to a tippee (b) in exchange for a personal benefit; (3) the tippee knew of the tipper's breach, that is, he knew the information was confidential and divulged for personal benefit; and (4) the tippee still used that information to trade in a security or tip another individual for personal benefit.") *Id.*at 452.
[800] *Salman v. U.S.*, 137 S. CT. 420, 428 (U.S. 2016).
[801] *LANGEVOORT, supra* note *6, at* §4:6.

meaningfully close relationship between the tipper and the tippee to meet the personal benefit test.[802] More broadly, the Supreme Court referred to the government's argument that a gift of material non-public information to anyone, including relatives and friends, is enough to create securities fraud.[803] This is because the government argued that a tipper would personally benefit whenever the disclosure was not for corporate purposes.[804] The Supreme Court also did not either approve or reject the government's argument of whether the mere disclosure of material non-public information to anyone without a legitimate business reason would ensue federal securities fraud under Rule 10b-5 disregarding the nature of the relationship between the tipper and tippee.[805]

In the wake of *Salamn*, the Second Circuit's recent decision, in *United States v. Martoma*,[806] understood the *Salman* decision as repealing the first part of *Newman's*

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[802] *LANGEVOORT, supra* note *6, at* §4:7.
[803] *Salman,* 137 S. Ct. at 427-28.
[804] *Id*.
[805] *LANGEVOORT, supra* note *6, at* §4:7.
[806] 869 F.3d 58 (2nd Cir. 2017). (Martoma was convicted by the District Court for committing securities fraud and conspiracy to commit securities fraud in connection with an insider trading scheme. *U.S. v. Martoma*, 48 F.Supp.3d 555 (S.D.N.Y. 2014). Martoma was employed as a portfolio manager at S.A.C., a hedge fund. *Id.*at 558. Through the use of an expert networking agency, Martoma could arrange a two-years' relationship with Dr. Sidney Gilman and Dr. Joel Ross, two experts in the field of Alzheimer's disease, who had been given access from Elan and Wyeth, in which Martoma had large securities holdings, to confidential information about the phase II clinical trial for an experimental drug to treat Alzheimer's disease. *Id*. The evidence showed that Dr. Gilman alone had 43 sessions with Martoma, mostly by phone. *Id*. The doctor shared confidential safety data concerning the clinical trial with Martoma. *Id*. Martoma paid $1000 per hour for each consultation with Dr. Gilman. *United States v. Martoma*, 869 F.3d 58, 61. Dr. Joel Ross met Martoma on many occasions and charged Martoma $1,500 per hour. *Id.*at 62. Dr. Roes shared with Martoma confidential information about the clinical trial, including information about his patients' responses to the drug and the total number of participants in the study that Dr. Ross recognized was not public. *Id*. After Dr. Gilman was "unblinded as to the final efficacy result of the trial…Dr. Gilman spoke with Martoma for about 90 minutes by telephone about what he had learned." *Id*. In a few days, S.A.C. "began to reduce its position in Ellan and Wyeth securities by entering short-sale and options trades that would be profitable if Ellan's and Wyeth's stock fell." *Id*. After the final result of the drug, "the share prices of Elan's and Wyeth had declined by about 42% and 12%, respectively." *Id*. Martoma and its firm gained "approximately $80.3 million in gains and $194.6 million in adverted losses for SAC. Martoma personally received a $9 million bonus based in large part on his trading activity in Elan and Wyeth." *Id.*at 62-63. The Second Circuit rejected *Martoma's* argument that there was no sufficient evidence presented in the trial based on the *Newman* standard to find illegal insider trading liability since the relationships with Dr. Gilman was not a "meaningfully close personal relationship" and the doctor did not receive any "objective consequential…gain of a pecuniary or similarly

requirement: a "meaningful close personal relationship."[807] This is because the Second Circuit noted that the right question under *Dirks* is whether a tipper personally benefits from a disclosure of confidential information upon which he/she violates his/her fiduciary duty.[808] The holding of *Martoma* was that a gift of confidential information is inferred when the disclosure was made with the expectation that the recipient will trade on the information where the disclosure is the same as trading by the tipper followed by a gift of the profits to the recipient.[809] The Second Circuit stated that although *Salman* did not specifically hold that gifts of confidential information to anyone satisfies the personal benefit test, the straightforward logic of *Salman* is that the disclosure by the tipper is the functional equivalent of trading on the information by the tipper and giving a cash gift to the recipient.[810] "[N]othing in *Salman's* reaffirmation of this logic supports a distinction between gifts to people with whom a tipper shares a 'meaningfully close personal

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valuable nature" in exchange for the disclosure of confidential information .*Id.*at 65-67. The Second Circuit held that "where Dr. Gilman regularly disclosed confidential information in exchange for fees, 'a rational trier of fact could have found the essential elements of the crime [of insider trading] beyond a reasonable doubt" under a pecuniary *quid pro quo* theory.'" *Id.*at 67. "That is exactly what happened in this case. Martoma was a frequent and lucrative client for Dr. Gilman, who was paid $1,000 per hour for approximately 43 consultation sessions. At the same time, Dr. Gilman was regularly feeding Martoma confidential information about the safety results of clinical trials involving bapineuzumab. When Dr. Gilman gained access to the final clinical study efficacy data in July 2008, he immediately passed it along to Martoma." *Id*. The Second Circuit also rejected the second argument presented by Martoma that "even if the evidence was sufficient to support his conviction, the district court's jury instructions were inadequate in light of *Newman* because they did not inform the jury about the limitations on 'personal benefit' developed in *Newman*. This inadequate instruction, Martoma argued, warranted a retrial." *Id*. at 65. "Martoma focuses on the language about developing friendships, arguing that gifts given to develop future friendships do not give rise to the personal benefit needed to trigger insider trading liability." *Id.*at 73. The Second Circuit held that: "Even if the jury instruction was obviously erroneous—which we hold it was not—that error did not impair Martoma's substantial rights in light of the compelling evidence that Dr. Gilman, the tipper, received substantial financial benefit in exchange for providing confidential information to Martoma." *Id*. The Second Circuit affirmed the judgement of the District Court.) *Id. at* 74.

[807] *United States v. Martoma*, 869 F.3d 58, 69. (2nd Cir. 2017).

[808] *Id.* at 68.

[809] *Id.*at 70. *See LANGEVOORT, supra* note *6, at* §4:7.

[810]*Martoma*, 869 F.3d at 69.

relationship' and gifts to those with whom a tipper does not share such a relationship."[811] The Second Circuit clarified that its holding did not eliminate the personal benefit test but it merely found that it is possible for an insider to personally benefit from the disclosure of confidential information to a tippee with whom the insider does not share a meaningfully close relationship.[812] The Court also noted:

> Although we hold that *Newman*'s "meaningfully close personal relationship" requirement is no longer good law, we do not hold that the relationship between the tipper and tippee cannot be relevant to the jury in assessing competing narratives as to whether information was disclosed "with the expectation that [the recipient] would trade on it," and whether the disclosure "resemble[d] trading by the insider followed by a gift of the profits to the recipient.[813]

Professor Donald C. Langevoort stated that "sufficient evidence suggests that a breach of duty satisfying the Dirks test exist whenever a corporate insider passes valuable information to the tippee without an apparently legitimate business or personal justification."[814] Professor Lnagevoort suggested that this inference "makes a great deal of sense. Disloyalty occur anytime that a fiduciary treats information entrusted to him as if it were his own to do with as he pleases."[815] Langevoort strongly predicted that this presumption of personal benefit "will become a standard enforcement tactic in situations where the relationship between the tipper and tippee is not all that close, or where the gift occurs in a business rather than personal setting."[816]

<u>"Know or Should Know" Test</u>

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[811] *Id.*
[812] *Id.*at 71.
[813] *Id.*at 71 Nt. 8. *See* PICKHOLZ ET AL, *supra* note 646, at § 7:27.
[814] *LANGEVOORT, supra* note *6, at* §4:7.
[815] *Id.*
[816] *Id.*

After demonstrating that the tip was for a personal benefit, the tippee liability depends on the other part of the tippee liability standard, established in *Dirks*: whether the tippee knows or should have known that the disclosure was a breach of the tipper fiduciary duty in exchange for a personal benefit.[817] This element was clarified by the Second Circuit, in *S.E.C. v. Obus*,[818] that stated a "tippee liability can be established if a tippee knew or had reason to know that confidential information was initially obtained and transmitted improperly (and thus through deception)."[819] In *Newman*, the Second Circuit reaffirmed its stance in *Obus* and added that even for remote tippees, to be found liable for illegal inside trading, the government must prove, among other elements, that "the tippee knew of the tipper's breach, that is, he knew the information was confidential and divulged for personal benefit."[820]

This element was not an issue in *Salman*; however, the Supreme Court referred to the government's acknowledgement that: "to establish a defendant's criminal liability as a tippee, it must prove that the tippee knew that the tipper breached a duty—in other words, that the tippee knew that the tipper disclosed the information for a personal benefit and that the tipper expected trading to ensue."[821] Therefore, the *Newman* requirement that the tippee, including a secondary or remote tippee,[822] must know that the tipper disclosed the

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[817] PICKHOLZ ET AL, *supra* note 646, at §7:27; HAZEN*, supra* note 2, at §12:167.
[818] 693 F.3d 276 (2012)
[819] *Id.*at 288.
[820] *U.S. v. Newman*, 773 F.3d 438, 450 (2014). (The Court rejected the government's argument that it was not required to prove that the defendants knew that the inside tippers received a personal benefit, but rather it was required, based on the Second Circuit's decision in *Obus*, that defendants knew that insiders had disclosed this information in a breach of a duty of confidentiality. *Id.*at 448. *See Pritchard*, *supra* note 486, at 858. However, Professor Donald C. Langevoort noticed that "the court was being more stringent because of the criminal nature of the case, leaving the broader *Dirk* language and its interpretation in *Obus* to control in civil cases." *LANGEVOORT, supra* note *6, at* §4:10.
[821] *Salman v. U.S.*, 137 S. CT. 420, 427 (U.S. 2016).
[822] Remote tippees are "tippees who receive inside information from another tippee, rather than the tipper" Salman, 137 S. CT. at 426. For more discussion about remote tippees liability *see*, Francisco A. Loayza, *The*

information for a personal benefit was still in effect after *Salman* and *Martoma*.[823] Professor Langevoort suggested that "*Salman* implicitly made clear that such knowledge relates solely to the original tipper's motivation even when the tippee is a step or more removed from the tip."[824]

Professor Thomas Lee Hazen further analyzed the standard of tipper/tippee lability after *Salman*[825] and finds it involved four rules: (1) tipping without a personal benefit is insufficient to find a tippee liable for trading on material non-public information; (2) a personal benefit does not need to be pecuniary in nature and disclosing confidential information as a gift to a relative or friend is by itself enough to establish liability; (3) if the personal benefit is alleged to be in the form of a gift to a friend, it "is not necessary to weigh the closeness of the friendship," but rather the personal benefit is established when the tipper "providing the tip, knowing he or she will trade on it, in lieu of a cash gift to the tippee;" and (4) the tippee must know about the personal benefit to the tipper.[826]

<u>SEC's Regulation FD (Fair Disclosure)</u>

Remote Tippee Dilemma: Resolving Tippee more than Thirty Years After Dirks v. SEC, California Western Law Review, Vol. 52: No. 1, Article 6 (2015); Kathleen Coles, *The Dilemma of the Remote Tippee*, 41 Gonzaga. L. Rev. 181, 217 (2006).

[823] PICKHOLZ ET AL, *supra* note 646, at §7:27; HAZEN, *supra* note 2, at §12:167; *LANGEVOORT, supra* note *6, at* §4:10.

[824] *LANGEVOORT, supra* note *6, at* §6:13.

[825] HAZEN, *supra* note 2, at §12:167.

[826] *Id*.

Another issue that the SEC has been concerned about is selective disclosure of material non-public information from issuers and persons acting on their behalf, of material non-public information to securities analysts and other market professionals, but not to the general public.[827] One of the main concerns of the SEC about selective disclosure of inside information without public disclosure is its adverse effect on investors' confidence in the integrity and fairness of the capital markets. Investors realize that selective disclosure to selected securities analysts, institutional investors or other market professionals would help them unfairly trade or tip on the basis of the information and make profits or avoid loses but others would lack the same opportunity.[828] This is a practice that the SEC has viewed as closely resembling tipping and illegal corporate insider trading violations.[829] However, the SEC has not successfully targeted this practice through traditional tipping and illegal corporate insider judicial charges under Rule 10b-5 because of *Dirks'* personal benefit test.[830] The SEC noted that "many have viewed Dirks as affording considerable protection to insiders who make selective disclosures to analysts, and to the analysts (and their clients) who receive selectively disclosed information."[831]In 2000, the SEC adopted Regulation FD with the goal of leveling the playing field by requiring issuers to publicly disclose whenever they make a selective disclosure or to keep material non-public information undisclosed.[832]

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[827] SEC. EXCH. COMM'N, RELEASE NO. 7881, Selective Disclosure and Insider Trading, at 2 (Aug. 15, 2000); *LANGEVOORT, supra* note *6, at* §12:12.
[828] *Id*.
[829] SEC. EXCH. COMM'N, RELEASE NO. 7881, at 2.
[830] *LANGEVOORT, supra* note *6, at* §12:12.
[831] Selective Disclosure and Insider Trading, 64 Fed. Reg. 72590-01, at 72593.
[832] SEC. EXCH. COMM'N, RELEASE NO. 7881, at 3; *LANGEVOORT, supra* note *6, at* §12:12; HAZEN*, supra* note 2, at §12:186.

Rule 100(a) of Regulation FD requires public disclosure "[w]henever an issuer,[833] or any person acting on its behalf, discloses any material nonpublic information regarding that issuer or its securities"[834] to particular persons: "(1) [s]imultaneously, in the case of an intentional disclosure; and (2) Promptly, in the case of a non-intentional disclosure."[835] The requirement to make a public disclosure is triggered when the disclosure of material non-public information is made to specific enumerated persons who are most likely to trade on the basis of the disclosed information or to advice others to trade in the related security.[836] Rule 100(b)(1) enumerates four types of persons to whom selective disclosure shall not be made without public disclosure.[837] These persons are (1) brokers or dealers and their associated persons; (2) investment advisers, institutional investment managers, or persons associated with either of them; (3) investment companies, hedge funds and their affiliated persons;[838] and (4) holders of the issuer's securities in which it is reasonably foreseeable that such security holder will purchase or sell the issuer's securities on the basis of the information disclosed.[839] However, Regulation FD does not apply to persons engaged in ordinary-course business communication with the issuer, such as communication with the issuer's customers, or suppliers.[840] It also does not include the

[833] Rule 101(b) of Regulation FD states that this regulation applies to any issuer with securities registered under §12 of the SEA or issuers required to file reports under § 15(d) of the SEA. This includes closed-end investment companies but excludes other investment companies, foreign government, and foreign private issuers. Regulation FD, 17 C.F. R. §243.101(b). *See* SEC. EXCH. COMM'N, RELEASE NO. 7881, at 19; *WANG & STEINBERG, supra* note *5, at* 346.
[834] Rule 100, 17 C.F. R. §243.100(a).
[835] *Id. See LANGEVOORT, supra* note *6, at* §12:12; *WANG & STEINBERG, supra* note *5, at* 338.
[836] SEC. EXCH. COMM'N, RELEASE NO. 7881, at 7; *LANGEVOORT, supra* note *6, at* §12:12.
[837] Regulaiton FD, 17 C.F. R. §243.100(b)(1).
[838] SEC. EXCH. COMM'N, RELEASE NO. 7881, at 7. (These three "categories will include sell-side analysts, many buy-side analysts, large institutional investment managers, and other market professionals who may be likely to trade on the basis of selectively disclosed information.") *Id*.
[839] Regulation FD, 17 C.F. R. §243.100(b)(1)(i) to (iv).
[840] SEC. EXCH. COMM'N, RELEASE NO. 7881, at 8; *WANG & STEINBERG, supra* note *5, at* 338.

disclosure by the issuer to the media or government agencies.[841] Rule 100(b)(2) excludes from coverage of Regulation FD communications made to (1) persons who owe the issuer a duty of trust or confidence, such as temporary insiders (e.g., an attorney, investment banker, or accountant); and (2) persons who expressly agree to maintain the disclosed information in confidence;[842] It also excludes disclosures made (3) in connection with a securities offering registered under the Securities Act with certain rules and exceptions.[843]

Rule 101(c) of Regulation FD defined a "person acting on behalf of an issuer" to apply upon (1) any senior official of the issuer;[844] or (2) any other officer, employee, or agent of an issuer who regularly communicates with those enumerated persons under Rule 100(b)(1).[845] This covers senior management, investor relations professionals and others who regularly communicate with market professionals or security holders.[846] However, a disclosure by low-level employees who do not have investor relations responsibility is not covered by Regulation FD unless the disclosure was directed by the issuer or other covered persons.[847] In addition, a disclosure by these officials is not deemed to be on behalf of an issuer if the disclosure is in breach of a duty of trust or confidence.[848] For example

[841] *Id*.
[842] SEC. EXCH. COMM'N, RELEASE NO. 7881, at 8. (The SEC noted that any misuse of the information for trading by the persons in these two exclusions would thus be covered under either the 'temporary insider' or the misappropriation theory of insider trading.") *Id*. *See WANG & STEINBERG, supra* note *5, at* 339.
[843] Regulation FD, 17 C.F. R. §243.100(b)(2)(i) to (iii). *See WANG & STEINBERG, supra* note *5, at* 339; HAZEN*, supra* note 2, at §12:186; *LANGEVOORT, supra* note *6, at* §12:18.
[844] Rule 101(f) of Regulation FD defines "senior official" as "any director, executive officer[], investor relations or public relations officer, or other person with similar functions." Regulation FD, 17 C.F. R. §243.101(f).
[845] Regulation FD, 17 C.F. R. §243.100(c). *See WANG & STEINBERG, supra* note *5, at* 340.
[846] SEC. EXCH. COMM'N, RELEASE NO. 7881, Selective Disclosure and Insider Trading, at 9 (Aug. 15, 2000).
[847] *Id*; *LANGEVOORT, supra* note *6, at* §12:13.
[848] Regulation FD, 17 C.F. R. §243.100(c). *See LANGEVOORT, supra* note *6, at* §12:13.

unauthorized disclosure by an officer to a friend does not trigger the public disclosure requirement under Regulation FD.[849]

Rule 101(e) gives the issuer broad flexibility to determine how to make public disclosure.[850] It gives the issuer the option to disclose either (1) by furnishing to or filing with the SEC a Form 8-K to disclose the information;[851] or (2) to disseminate the information through another method or combination of methods "of disclosure that is reasonably designed to provide broad, non-exclusionary distribution of the information to the public."[852]

The timing of public disclosure varies according to whether the selective disclosure is "intentional" or "non-intentional."[853] Rule 101(a) defines intentional selective disclosure as "when the person making the disclosure either knows, or is reckless in not knowing, that the information he or she is communicating is both material and nonpublic."[854] Therefore, if the disclosure is intentional, the public disclosure must be made at the same time as the selective disclosure.[855] Issuers also are required to "promptly" make public disclosure whenever non-intentional selective disclosure is made.[856] Rule 101(d) defines "promptly" as soon as reasonably practicable, but not later than 24 hours or the commencement of the next day's trading on the New York Stock Exchange, after a senior official of the issuer

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849 *LANGEVOORT, supra* note *6, at* §12:13.
850 SEC. EXCH. COMM'N, RELEASE NO. 7881, at 13. *See* Regulation FD, 17 C.F. R. §243.101(e).
851 Form 8-K is an "SEC form that a registered corporation must file if a material event affecting its financial condition occurs between the due dates for regular SEC filings." Black's Law Dictionary, 8-K (10th ed. 2014) *available at* West Law.
852 Regulation FD, 17 C.F. R. §243.101(e)(1), (2). *See WANG & STEINBERG, supra* note *5, at* 342.
853 *See* SEC. EXCH. COMM'N, RELEASE NO. 7881, at 12; *LANGEVOORT, supra* note *6, at* §12:16.
854 Regulation FD, 17 C.F. R. §243.101(a). *See LANGEVOORT, supra* note *6, at* §12:16; *WANG & STEINBERG, supra* note *5, at* 341.
855 The standard of materiality liability arises "when no reasonable person under the circumstances would have made the same determination." *SEC Release Notice*, Release No. 7881, *supra* note 423, at 12.
856 Rule 100, 17 C.F. R. §243.100(a).

learns about the non-intentional disclosure of information that the senior official knows or is reckless in not knowing is both martial and nonpublic.[857]

Rule 102 of Regulation FD makes it clear that failure to make a public disclosure required solely by Regulation FD shall not be deemed to be a violation of Rule 10b-5.[858] However, liability under Rule 10b-5 may arise if the selective disclosure meets *Dirks'* personal benefit test.[859] A sole violation of Regulation FD can result in SEC enforcement action as a violation of Section 13(a) or Section 15(d) of the SEA.[860]

Rule 14e-3(d): The Anti-Tipping Rule in a Tender Offer Context

Rule 14e-3(a) prohibits classical and temporary insiders of both the offeror and the target company as well as their tippees from trading on material non-public information related a tender offer unless they disclose the information and its source to the public.[861] In addition to the prohibition of trading on such information, Rule 14e-3(d)(1) imposes an anti-tipping provision upon certain persons enumerated under Rule 14e-3(d)(2). Rule 14e-3(d)(1) reads:

> As a means reasonably designed to prevent fraudulent, deceptive or manipulative acts or practices within the meaning of section 14(e) of the Act, it shall be unlawful for any person described in paragraph (d)(2) of this section to communicate material, nonpublic information relating to a tender offer to any other person under circumstances in which it is reasonably foreseeable that such communication is likely to result in a violation of this section.[862]

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[857] Regulation FD, 17 C.F. R. §243.101(d). *See LANGEVOORT, supra* note *6, at* §12:16. (The SEC did not provide a special definition of "material" and "nonpublic information" under Regulation FD noting that the definition of these terms is the same as it was established in case law under securities laws.) SEC. EXCH. COMM'N, RELEASE NO. 7881, at 9; *LANGEVOORT, supra* note *6, at* §12:14.
[858] Regulation FD, 17 C.F. R. §243.102.
[859] SEC. EXCH. COMM'N, RELEASE NO. 7881, at 20; *WANG & STEINBERG, supra* note *5, at* 346.
[860] *Id.*
[861] *See Supra* §1.2.2.3.2. *See* also, ARNOLD S. JACOBS, THE WILLIAMS ACT -- TENDER OFFERS AND STOCK ACCUMULATIONS, §5:40, Westlaw (database updated Feb. 2019).
[862] Rule 14e-3(d)(1), 17 C.F.R. §240.14e-3(d)(1).

Rule 14e-3(d) is designed to prevent market disparities in market information by proscribing certain persons in possession of material non-public information about a tender offer from selective communications and leaking this information to anyone.[863] The SEC clarified that this anti-tipping rule contains two elements: (1) the communicating person must possess material non-public information related to a tender offer;[864] and (2) such person tips this information to another person.[865]

Rule 14e-3(d)(2) enumerates the persons subject to the anti-tipping rule which can be grouped into two categories as follows: (1) persons occupy certain status.[866] This include the offeror, the target company, any officers, directors, partners, employees, advisors of the offeror or the target company, or any other persons acting on behalf of the offeror or the target company; (2) tippees of the foregoing persons who possess material information related to a tender offer which information that they know or have reason to know is nonpublic and that they know or have reason to know has been acquired directly or indirectly from any of the above.[867] Thus, this rule covers intermediate-level tippees who although do not trade on the information, but they leak the information to others.[868]

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[863] SEC. EXCH. COMM'N, RELEASE NO. 6239, Tender Offers, at 12 (Sept. 4, 1980). *See LANGEVOORT, supra* note *6, at* §7:9.
[864] *Id*. (The SEC noted that the person in possession of material non-public information can be a person who creates such information such as the offeror or it can be a person who receives or obtains the information from the offeror or the target company or another person who is "in a chain" from the offeror or the target company) *Id*. *See JACOBS*, *supra* note 860, at §5:43.
[865] SEC. EXCH. COMM'N, RELEASE NO. 6239, at 12.
[866] *Id*.
[867] Rule 14e-3(d)(2), 17 C.F.R. §240.14e-3(d)(2). *See Id*; *LANGEVOORT, supra* note *6, at* §7:9; *WANG & STEINBERG, supra* note *5, at* 724.
[868] SEC. EXCH. COMM'N, RELEASE NO. 6239, Tender Offers, at 12 (Sept. 4, 1980). *See LANGEVOORT, supra* note *6, at* §7:9. (Professor Donald Langevoort notes that "[t]his portion of the rule does not address tippee liability. Tippee liability is included in the primary trading prohibition, because a tip creates the circumstances under which a person can have sufficient awareness of the nonpublic nature of the information and the source from which it came. Courts have tended to invoke case law from tipper-tippee liability generally in assessing the awareness questions." *Id*. at Nt. 1.

The standard of tipping liability under this rule is that the communicating person tips the information to another while it is reasonably foreseeable that such communication is likely to result in a violation of Rule 14e-3(a) or 14e-3(d).[869] However, the SEC ensured that "this rule is not intended to have an impact on casual and innocently motivated social discourse."[870] Rather, the rule applies when the circumstances make it reasonably foreseeable that a violation of Rule 14e-3 is likely to occur.[871] Such circumstances include, the identity, position, reputation, or prior actions of the listener that a reasonable person would find it reasonably foreseeable that the communicated information would be used in violation of Rule 14e-3.[872] Professor Donald C. Langevoort suggested that "the insider is safe if he simply 'lets slip' confidential information to friends or associates. But once he is aware that potential listener is active investor, or regularly in contact with active investor, then he must be careful to keep the information to himself."[873] Thus, the SEC urges persons in possession of material non-public information related to a tender offer to exercise all due care in their communication.[874]

Rule 14e-3(d)(1) provides an exception from the anti-tipping rule for the purpose of protecting the offeror and target company conducting a tender offer from undesirable exposure to liability under Rule 14e-3.[875] Rule 14e-3(1) provides that the anti-tipping provision does not apply to communication made in good faith to (1) any officers, directors, partners, employees of the offeror or the target company; (2) to other persons involved in

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[869] SEC. EXCH. COMM'N, RELEASE NO. 6239, at 12.
[870] *Id.*at 13.
[871] *Id. See WANG & STEINBERG, supra* note *5, at* 723.
[872] Tender Offers Release, *supra* note 245, at 13.; JACOBS, *supra* note 860, at §5:43.
[873] *LANGEVOORT, supra* note *6, at* §7:9.
[874] SEC. EXCH. COMM'N, RELEASE NO. 6239, at 12., at 13.
[875] *Id. See WANG & STEINBERG, supra* note *5, at* 723; *LANGEVOORT, supra* note *6, at* §7:9; JACOBS, *supra* note 860, at §5:43.

the planning, financing, preparation, or execution of the tender offer; and (3) to any person pursuant to a requirement of any statute or rule or regulation.[876] Therefore, insiders of the offeror or the target company may disclose material non-public information about the tender offer to brokers/dealers or investment advisors and others who are engaged in the tender offer deal without being subject to the proscription of the anti-tipping rule.[877] Nevertheless, the standard of this affirmative defense against liability under this rule hinges on whether the communication was conducted in good faith.[878] Therefore, a person who claims the availability of this good faith exception must establish evidence showing that the information was communicated in good faith.[879] As a result, the exception is available if the communicating person proves that he/she did not know or have reason to know that the exempted recipient of the information was going to violate Rule 14e-3.[880]

Definition of Material Non-public Information

The strategic position that corporate insiders occupy inside their corporations gives them the opportunity to be more sophisticated about the financial condition of their corporations and empowers them to form more accurate investment decisions compared to outsiders.[881] However, the law of illegal corporate insider trading does not proscribe trading based on financial sophistication nor does it prohibit insiders from trading on the basis of their superior insight and more accurate assessment about their corporation and the

[876] Rule 14e-3(d)(1), 17 C.F.R. §240.14e-3(d)(1); SEC. EXCH. COMM'N, RELEASE NO. 6239, at 12., at 13; *WANG & STEINBERG, supra* note *5, at* 723.
[877] *LANGEVOORT, supra* note *6, at* §7:9.
[878] SEC. EXCH. COMM'N, RELEASE NO. 6239, Tender Offers, at 13 (Sept. 4, 1980). *See* JACOBS, *supra* note 860, at §5:43; *LANGEVOORT, supra* note *6, at* §7:9.
[879] *Id*.
[880] *Id*.
[881] *See LANGEVOORT, supra* note *6, at* §5:1.

value of its traded security.[882] The objective of illegal corporate insider trading law is to prevent insiders from gaining free-risk profits by trading on information that could affect future changes and which has not yet been made public will substantially affect the security market price.[883] By doing so, corporate insiders breach their duty of trust and confidence by not disclosing the information to the virtual beneficiaries before they unfairly trade and reap ill-gotten profits or avoid loses. Nevertheless, in securities laws, it has been judicially established that not all information is equal in terms of value and importance to the shareholders.[884] Therefore, the concept of materiality was established, and insiders were required to disclose only material information.[885]

The terms "material" and "non-public" information under the law of illegal corporate insider trading lack statutory definitions.[886] Courts and the SEC, on the other hand, have not provided a bright-line rule for the purpose of determining "materiality" or what is considered "non-public" in an illegal corporate insider trading context.[887] However,

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882 *See Id*. The Second Circuit, in *SEC & Texas Gulf Sulphur CO*., 401 F.2d 833 (2d Cir. 1968), stated that: "An insider is not, of course, always foreclosed from investing in his own company merely because he may be more familiar with company operations than are outside investors... Nor is an insider obligated to confer upon outside investors the benefit of his superior financial or other expert analysis by disclosing his educated guesses or predictions." *Id*. at 848.

883 *Id*.

884 Richard C. Sauer, T*he Erosion of the Materiality Standard in the Enforcement of the Federal Securities Laws*, 62 Bus. Law. 317, 318 (2007).

885 The Supreme Court, in *Basic Inc., v. Levinsion*, illustrated the standard of materiality it adopted, in *TSC Industries, Inc. v. Northway, Inc*., 426 U.S. 438, 448 (1976), noting that the adopted standard "[a]cknowledging that certain information concerning corporate developments could well be of 'dubious significance,' the Court was careful not to set too low a standard of materiality; it was concerned that a minimal standard might bring an overabundance of information within its reach, and lead management "simply to bury the shareholders in an avalanche of trivial information—a result that is hardly conducive to informed decisionmaking." 485 U.S. 224, 233 (1988).

886 *See Schipani & Seyhun*, *supra* note 424, at 341.

887 In *Basic Inc., v. Levinson*, the United States Supreme Court rejected the plaintiff's claim urging the Court to adopt a bright-line rule by stating that "[a]ny approach that designates a single fact or occurrence as always determinative of an inherently fact-specific finding such as materiality, must necessarily be overinclusive or underinclusive." 485 U.S. 224, 236 (1988). This opinion was cited and reemphasized by the Supreme Court, recently, in *Matrixx Initiatives, Inc. v. Siracusano*, 563 U.S. 27, 39 (2011). *LANGEVOORT, supra* note *6, at* §5:2; *WANG & STEINBERG, supra* note *5, at* 99; HAZEN*, supra* note 2, at §12:60. *See* also Joan Macleod

courts have established a fact-based inquiry focusing on the surrounding circumstances and all available information to the public when the trading took place.[888] This part seeks to define "material" and "non-public" information by determining the current judicial and administrative definitions of these terms. It also discusses the mechanisms that have been used in the analysis of the materiality and public nature of information.

Material Information

Courts took the concept of materiality from the common law fraud context and have applied it to cases brought under Rule 10b-5.[889] In an illegal corporate insider trading case, to determine that an insider has violated the duty to disclose or abstain from trading, the information must be material to invoke the duty to disclose.[890] Immaterial non-public information is out of the scope of the duty to disclose or abstain.[891].

The Supreme Court adopted an objective standard of materiality under Rule 10b-5 that the Court established, in *TSC Industries, Inc. v. Northway, Inc*., in the context of omissions of material facts in proxy-solicitation under Rule 14a-9 promulgated under Section 14(a) of the SEA.[892] The Supreme Court stated that the "materiality requirement is satisfied when there is 'a substantial likelihood that the disclosure of the omitted fact would

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Heminway, *Materiality Guidance in the Context of Insider Trading: A Call for Action*, 52 Am. U. L. Rev. 1131 (2003); *Sauer*, *supra* note 884, at 324.

[888] HAZEN*, supra* note 2, at §12:60.

[889] *Id*.

[890] *WANG & STEINBERG, supra* note *5, at* 107.

[891] *Id*; *LANGEVOORT, supra* note *6, at* §5:2.

[892] *Basic Inc., v. Levinson,* 485 U.S. 224, 231-32 (1988). (The Supreme Court stated that: "[t]he Court also explicitly has defined a standard of materiality under the securities laws, concluding in the proxy-solicitation context that '[a]n omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote.' It further explained that to fulfill the materiality requirement 'there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available.' We now expressly adopt the *TSC Industries* standard of materiality for the § 10(b) and Rule 10b–5 context.") *Id*.

have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available.'"[893] The Supreme Court, in *TSC Industries, Inc. v. Northway,* rejected another standard of materiality that includes "all facts which a reasonable shareholder Might consider important."[894] The Court's rationale for its rejection to this standard was that it imposes a low standard that would expose management to liability for insignificant omissions, and may cause management to "simply bury the shareholders in an avalanche of trivial information a result that is hardly conducive to informed decision making."[895]

This materiality standard, however, was not applied by the Supreme Court in an illegal corporate insider trading case before the Supreme Court, in *Basic Inc., v. Levinson*.[896] However, it noted that "no authority in the statute, the legislative history, or [] previous decisions for varying the standard of materiality depending on who brings the action or whether insiders are alleged to have profited."[897] Subsequently, Courts have applied this standard as the general authority to determine materiality in illegal corporate insider trading cases.[898] The question of materiality is a question of law and fact.[899] Based

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[893] *Matrixx Initiatives, Inc. v. Siracusano*, 563 U.S. 27, 39 (2011). Citing *Basic Inc., v. Levinson,* 485 U.S. 224, 238.
[894] *TSC Industries, Inc. v. Northway, Inc*., 426 U.S. 438, 445 (1976).
[895] *Id.*at 448-49.
[896] *WANG & STEINBERG, supra* note *5, at* 108.
[897] *Basic Inc., v. Levinson,* 485 U.S. 224, 240 Nt. 18. (1988). *See id*.
[898] *LANGEVOORT, supra* note *6, at* §5:2; *Sauer*, *supra* note 884, at 320-21; *WANG & STEINBERG, supra* note *5, at* 107. *See U.S. v. Contorinis,* 692 F.3d 136 (2nd Cir. 2012); SEC. EXCH. COMM'N, RELEASE NO. 7881, Selective Disclosure and Insider Trading, at 12 (Aug. 15, 2000).
[899] *LANGEVOORT, supra* note *6, at* §5:2; *WANG & STEINBERG, supra* note *5, at* 108 Nt. 36. *See SEC V. Hoover*, 903 F. Supp. 1135, 1040 (S.D. Tex. 1995). (The District Court of Southern Texas stated that the TSC's standard of materiality is applied in illegal insider trading cases noting that materiality is a mixed question of law and fact.) *Id*; *SEC v. Mayhew,* 121 F.3d 44, 52 (2nd. Cir. 1997). (The Second Circuit noted that "[t]he legal component depends on whether the information is relevant to a given question in light of the controlling substantive law. The factual component requires an inference as to whether the information would likely be given weight by a person considering that question.'") *Id*.

on this standard, material information is information that if it were available to a reasonable investor in addition to other available information, it would be likely but not certain, to cause a reasonable investor to reevaluate the stock price and whether to purchase or sell.[900] However, the reasonable investor standard can be described as a general framework that was not designed for immediate application in various cases.[901] For the purpose of the determination of materiality in illegal corporate insider trading cases, courts have applied multiple factors to determine the materiality of the information based on the reasonable investor standard.[902] While declining to provide an inclusive definition of materiality, the SEC provides some clarity by giving examples of facts that may be material under the circumstances.[903]

<u>Judicial Analysis of Materiality</u>

In general, the ultimate question of materiality is whether the information question would be viewed by a reasonable investor to alter his/her knowledge of what is already known publicly. This question is mostly answered positively by showing that the disclosure has impacted the market price of the related security whether in terms of an increase or decrease of the market price of the security.[904] Thus, the issue of materiality is less likely to be an issue in illegal corporate insider trading cases except when the information includes probable news of a change in the future, or the disclosure of the information has no impact on the related security market price.[905] There are three main factors that courts

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[900] *LANGEVOORT, supra* note *6, at* §5:2; *Heminway*, *supra* note 887, at 1137.
[901] *Sauer*, *supra* note 884, at 321; *Heminway*, at 1139.
[902] *See LANGEVOORT, supra* note *6, at* §5:2; *WANG & STEINBERG, supra* note *5, at* 111; *Heminway*, *supra* note 887, at 1137.
[903] *See infra* notes 979-82 and accompanying text.
[904] *LANGEVOORT, supra* note *6, at* §5:2.
[905] *See LANGEVOORT, supra* note *6, at* §5:2; *WANG & STEINBERG, supra* note *5, at* 116-17.

have considered to determine whether there is a substantial likelihood that the disclosure of such information would be viewed by a reasonable investor as a significant change in the "total mix" of information that is publicly available.[906] The test focuses on the probability and magnitude, the market reaction after the disclosure, and the importance attached to the information. These tests are examined below.

a. The Probability and Magnitude Test—Corporate Acquisitions

The probability and magnitude test is one of the factors used by courts to determine the materiality of information that the insider was aware of at the time of trading.[907] This test is used in various types of situations where the information is related to events that are uncertain to occur in the future or are speculative in nature.[908] Courts apply the probability magnitude test, mostly to proposed tender offers, merger negotiations, and other corporate acquisitions.[909] The test is also applied when the information is unreliable or vague.[910]

The probability and magnitude test was adopted by the Supreme Court, in *Basic*,[911] The Supreme Court noted that:

> Where the impact of the corporate development on the target's fortune is certain and clear, the *TSC Industries* materiality definition admits straightforward

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[906] *See LANGEVOORT, supra* note *6, at* §5:2; *WANG & STEINBERG, supra* note *5, at* 111; *Heminway*, *supra* note 887, at 1153; HAZEN*, supra* note 2, at §12:60; *Schipani & Seyhun*, *supra* note 424, at 341; *Sauer*, *supra* note 884, at 323.
[907] *LANGEVOORT, supra* note *6, at* §5:2; *WANG & STEINBERG, supra* note *5, at* 118.
[908] *Basic Inc., v. Levinson,* 485 U.S. 224, 232 (1988).
[909] *LANGEVOORT, supra* note *6, at* §5:2; *WANG & STEINBERG, supra* note *5, at* 118.
[910] *Id.*
[911] 485 U.S. 224. (One of the issues reviewed by the Supreme Court in this case was the issue of the determination of materiality in the context of preliminary corporate merger discussions. *Id.*at 230. The related facts were that Basic Corporation was approached by Combustion Corporation representatives concerning the possibility of a merger. The conversations were held with officers and directors of Basic. However, Basic issued three public statements denying that it was engaged in merger negotiations. On December 18, 1978, Basic announced for the first time that it had been approached by another company concerning a merger. The following day Basic announced its Board of Directors approval for Combustion's tender offer for all outstanding shares for $46 per share. *Id.*at 227-28. The respondents were former shareholders of Basic who sold their shares during the time of the three denying statements issued by Basic alleging that the denying statements of merger negotiations were misleading and false and thus in violation of §10(b) and Rule 10b-5.

> application. Where, on the other hand, the event is contingent or speculative in nature, it is difficult to ascertain whether the "reasonable investor" would have considered the omitted information significant at the time. Merger negotiations, because of the ever-present possibility that the contemplated transaction will not be effectuated, fall into the latter category."[912]

The Supreme Court endorsed the fact-specific test that had been applied by the Second Circuit, in *Texas Gulf Sulphur.*[913] The Supreme Court determined that the Second Circuit had indicated that the materiality requirement concerning contingent or speculative information is to be applied on a case-by-case basis. It "will depend at any given time upon a balancing of both the indicated probability that the event will occur and the anticipated magnitude of the event in light of the totality of the company activity."[914] The Supreme Court expressly agreed with this analysis.[915] In assessing the probability part of the test, the Supreme Court asserted that the factfinder would need to look to signs of interest at the highest corporate levels. Such signs include, for example, "board resolutions, instructions to investment bankers, and actual negotiations between principals or their intermediaries may serve as indicia of interest."[916] The magnitude part of the test can be assessed by looking to "such facts as the size of the two corporate entities and of the potential premiums over market value."[917]

On the basis of the probability and magnitude test, information related to potential mergers or other corporate acquisitions is material when the probability of the occurrence of such a merger is significant enough to change the total mix of publicly available

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[912] *Basic Inc., v. Levinson,* 485 U.S. 224, 232.
[913] *Id.*at 232-39. *See SEC. & Texas Gulf Sulphur CO.,*401 F.2d 833, 849 (2[nd] Cir.1968).
[914] *Basic Inc., v. Levinson,* 485 U.S. 224, 239 (1988) Citing *SEC. & Texas Gulf Sulphur CO.,*401 F.2d 833, 849.
[915] *Basic Inc., v. Levinson,* 485 U.S. 224, 239.
[916] *Id.*
[917] *Id. See WANG & STEINBERG, supra* note *5, at* 118.

information.[918] The mere invitation to consider the possibility of a merger, is not by itself a material fact.[919] However, if the invitation was positively received by the target company, such as by sharing confidential information with the potential acquirer, then the probability of the merger occurring would become greater and the materiality requirement may be satisfied.[920]

In illegal corporate insider trading cases, finding materiality based on the insider's awareness of potential mergers ranges from finding facts that the insider was certain that the merger or other types of acquisitions would occur to facts merely showing that the conclusion of the merger was speculative and uncertain.[921] In *SEC v. Mayhew*,[922] the Second Circuit found that the information was material when an outsider traded on the basis of confidential information received originally from an insider of the target company that the company "was being pursued and/or was actively pursuing companies to merge or integrate or acquire" and that "the company had been approached and was discussing alternatives as an active ongoing part of their life."[923] The Second Circuit applied the probability and magnitude test and concluded that although the information was general, it was material because it was received from an insider and it was related to a serious merger which was very important information that made it material, even at an early stage.[924] The United States District Court for the Southern District of New York, in *S.E.C. v. Wyly*,[925] found that controlling shareholders' desire to sell a corporation was immaterial

[918] *LANGEVOORT, supra* note *6, at* §5:2.
[919] *Id*.
[920] *Id*.
[921] *WANG & STEINBERG, supra* note *5, at* 118.
[922] *121 F.3d 44 (1997).*
[923] *Id*. at 48.
[924] *Id.*at 52. *See LANGEVOORT, supra* note *6, at* §5:2.
[925] (2014).

information.[926] The Second Circuit stated: "While bright line rules regarding when merger negotiations become material are disfavored, this Circuit's cases establish that something beyond desire to transact is necessary."[927]

This test of materiality could also be relevant in other contexts. The issue is whether general or unverified non-public information is material information. This issue is more likely to be argued by tippees who may allege that the information received form an insider was too general and thus immaterial.[928] The Second Circuit, in *Securities and Exchange Commission v. Monarch Fund,*[929] analyzed this issue and concluded that: "[c]ertainly the ability of court to find a violation of the securities laws diminishes in the proportion to the extent that disclosed information is so general that the recipient is still undertaking a substantial economic risk that his tempting target will prove to be 'white elephant.'"[930] The Court found that the general confirmation of a rumor that the company was seeking a private placement was immaterial since

> the information disclosed…by any standard, lacked the basic elements of specificity. No revelation was made of any underlying facts concerning the contemplated financing. No specific terms were divulged. Nor were the lenders identified. Nor was the date of the financing indicated, but only that the company 'expect(ed) it to be done shortly.'[931]

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[926] *Id.*at 301.

[927] *Id.*at 300. For more discussion about this test, *see LANGEVOORT, supra* note *6, at* §5:2; *WANG & STEINBERG, supra* note *5, at* 118; COX ET AL, *supra* note 7, at 732. *See* also *supra* note 483.

[928] *See WANG & STEINBERG, supra* note *5, at* 117.

[929] 698 F.2d 938 (2nd Cir. 1979).

[930] *Id.*at 942.

[931] Id.at 942. *Id*. *See S.E.C. v. Wyly,* 33 F.Supp. 3d 290, 300 (S.D.N.Y. 2014). *See* also Stuart Sinai, *Rumors, Possession v. Use, Fiduciary Duty and Other Current Insider Trading Considerations*, 55 Bus. Law. 743, 766 (2000). (The author suggests that "[t]his case may *see*m to indicate that the level of culpability under section 10(b) is somehow related to the specificity of the information received and that information from an insider that the company is merely attempting to effectuate a transaction that has already been widely rumored is no violation. That is, confirmation of something that is already the subject of speculation which reveals no more specific information than is already rumored, still leaves the investor with a 'substantial economic risk.'") *Id*.

The Court distinguished between corporate insiders and outsiders recognizing that insiders "almost by definition have a degree of knowledge that makes them culpable if they trade on inside information."[932] In contrast, the Court realized that it "may not make the same assumptions with regard to outsiders…since the kinds of factual situations in which they acquire their information are innumerable."[933] The Court found that there are two types of outsiders, a tippee "who knows or ought to know that he is trading on inside information, as against the outsider who has no reason to know he is trading on the basis of such knowledge."[934]

Subsequent cases, however, have distinguished *Monarch* in several aspects.[935] In *Dirks v. S.E.C.*,[936] the Second Circuit rejected Dirks' argument citing *Monarch* that the information he tipped to other investors was not specific enough to be considered a fact and it was received from a former insider whose words could be doubted.[937] The Second Circuit concluded that although the information was not specific, "by the end of Dirks' investigation there was no doubt that the information he possessed and passed on to his clients had enough specificity to satisfy Rule 10b-5. Thus, the information involved in this case was totally unlike the general rumors in the Monarch Fund, and thus the court found it was not specific enough to support Rule 10b-5 liability."[938] In *SEC v. Mayhew,* the Second Circuit distinguished *Monarch* in the context of general information regarding a

[932] *Securities and Exchange Commission v. Monarch Fund,* 698 F.2d 938, 41-42 (2nd Cir. 1979).
[933] *Id*.
[934] *Id*. *See S.E.C. v. Obus*, 693 F.3d 276, 288 Nt.2 (2nd Cir. 2012)
[935] *See Sinai*, *supra* note 931, at 766.
[936] 681 F.2d 824.
[937] *Id.*at 843.
[938] *Id*.

merger "where information regarding a merger originates from an insider, the information, even if not detailed, 'takes on an added charge just because it is inside information.'"[939]

Courts are more likely to find trading by a corporate insider on non-public information as material information even if it is vague or unspecific.[940] In *S.E.C. v. Happ*,[941] the United States Court of Appeals for the First Circuit found the information received through two voice messages was material information. A CEO of a company sent a message to the director and chairman of the Board of Directors' Audit Committee saying that the company was having some difficulties.[942] The First Circuit noted that "[i]n the circumstances…[W]e believe a rational jury could find that the information that Galileo was experiencing "difficulties," communicated by Hanley to Happ in voicemail messages near the end of the third quarter, constituted material, nonpublic information triggering his stock sale.[943]

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[939] *SEC v. Mayhew,* 121 F.3d 44, 52 (2nd Cir. 1997). *See U.S. v. Contorinis,* 692 F.3d 136,143-44 (2nd Cir. 2012). (The Second Circuit reviewed the case of illegal insider trading on inside information related to a corporate acquisition. In this case, the Court noted that "[i]nformation [] comes in varying degrees of specificity and reliability, and the extent to which a newly reported item of information alters the total mix may depend on the specificity or reliability of that information." *Id.*at 143. The Second Circuit concluded that a "trier of fact may find that information obtained from a particular insider, even if it mirrors rumors or press reports, is sufficiently more reliable, and, therefore, is material and nonpublic, because the insider tip alters the mix by confirming the rumor or reports.") *Id.*144.

[940] *See LANGEVOORT, supra* note *6, at* §5:2.

[941] 392 F.3d 12 (1st Cir. 2004).

[942] *Id.*at 22. *See LANGEVOORT, supra* note *6, at* §5:2.

[943] *Id*. *See* also *S.E.C. v. Trikilis*, No. CV 92-1336-RSWL(EEX), 1992 WL 301398, (C.D. Cal. July 28, 1992). (The District Court for the Southern District of California rejected the defendants' argument that a general and vague recommendation to buy shares in a corporation was immaterial because events occurring at the corporation would probably result in a price increase is immaterial. (The events were related to a tentative agreement to conduct a tender offer.) *Id.*at 4. The Court distinguished *Monarch's* test from this case in that this case involved an explicit recommendation to trade in a stock and an explicit prediction that the stock would arise, and a statement that this passed information was not public. *Id*. Therefore, the Court concluded that this conveyed information was not immaterial as a matter of law. The Court, finally, noted that the ultimate question in similar situations rests on the credibility of the source of the information.) *Id*.

b. Reaction of the Market after the Disclosure

Under an efficient capital market model, a security market price reflects all available public information about the related security, and the price of the related security reacts impartially and without delay to any new information.[944] Economics studies find that in a competitive market where many securities analysts and market professionals analyze the same information, the security market price will be a consensus price among these competing experts.[945] Observing this notion, Professor Donald C. Langevoort defined material information as "any information the disclosure of which would be likely to result in a substantial change in the price of the security."[946]

Courts and the SEC often cite the impact of the disclosure on the security market price to demonstrate a finding of materiality.[947] The Second Circuit, in *Elkind v. Liggett & Myers, Inc*.,[948] noted that the meaning of materiality in illegal corporate insider trading cases is that "the disclosed information must be 'reasonably certain to have a substantial effect on the market price of the security.'"[949] They based their finding that the mere confirmation of already common knowledge among public investors on "the fact that there would be a release added little to the already available wisdom of the market place (reflected by stock prices which had been falling for two weeks) that Liggett might be in a downturn."[950] In *U.S. v. Carpenter*,[951] the Second Circuit applied the *TSC's* reasonable

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[944] Roger J. Dennis, *Materiality and the Efficient Capital Market Model: A recipe from the Total Mix*, 25 Wm. & Mary L. Rev. 373, 374 (1983).
[945] *Id.*at 379.
[946] *LANGEVOORT, supra* note *6, at* §5:2.
[947] *See WANG & STEINBERG, supra* note *5, at* 113; *Heminway*, *supra* note 887, at 1158.
[948] 635 F.2d 156 (2nd Cir. 1980).
[949] *Id.*at 166. Citing *Securities and Exchange Commission v. Bausch & Lomb Inc.,* 565 F.2d 8, 15 (2nd Cir. 1977).
[950] *Id.*
[951] 791 F.2d 1024, (2nd Cir. 1986).

investors standard and noted that: “In our view, the satisfaction of this standard, even narrowly defined, is beyond question, given that the ‘Heard’ columns had undisputed significant market impact.”[952] The SEC has also used this standard, in *Cady, Roberts*,[953] where it found that “It was obvious that a reduction in the quarterly dividend by the Board of Directors was a material fact which could be expected to have an adverse impact on the market price of the company’s stock.”[954]

The absence of a market reaction to the disclosure of the related information can be used as an indicator that the information is immaterial.[955] However, Courts and the SEC repeatedly have stated that the materiality requirement is a fact-specific question and hence the lack or presence of a market reaction because of the disclosure is only one factor among others to be considered under the *TSC*’s reasonable investor standard.[956] Only the Third Circuit held that, “If a company’s disclosure of information has no effect on the company’s

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[952] *Id.*at 1032 Nt.9. *See* also *S.E.C. Warde,* 151 F.3d 42, 47(2nd Cir. 1998). (The Second Circuit found that “The facts that Hanson was accumulating Kidde stock and contemplating a tender offer, that KKR was also interested in bidding for Kidde, and that management was contemplating a leveraged buyout to fend off the unwelcome bids had a very high likelihood of affecting the price of Kidde’s stock, as confirmed by the fact that the stock price jumped when this information was made public. The evidence was clearly sufficient to support the jury’s conclusion that this inside information was material.”) *Id*.

[953] Cady, Roberts & Co., Re, 40 S.E.C. 907 (1961).

[954] *Id.*at 4. *See* JACOBS, *supra* note 93*,* at § 12:20.

[955] *See LANGEVOORT, supra* note *6, at* §5:2; *Sauer*, *supra* note 884, at 323.

[956] *Sauer*, *supra* note 884, at 323; *WANG & STEINBERG, supra* note *5, at* 113; *Heminway*, *supra* note 887, at 1159. *See No. 84 Employer-Teamster Joint Council Pension Tr. Fund v. Am. W. Holding Corp.,* 320 F.3d 920, 934 (9th Cir. 2003). (The Ninth Circuit rejected the “[d]efendants' argument for adoption of a bright-line rule requiring an immediate market reaction. [Finding that] [t]he market is subject to distortions that prevent the ideal of ‘a free and open public market’ from occurring…Because of these distortions, adoption of a bright-line rule assuming that the stock price will instantly react would fail to address the realities of the market. Thus, we decline to adopt a bright-line rule, and, instead, engage in the “fact-specific inquiry” set forth in *Basic*.”)Id. *See* also *SEC V. Hoover*, 903 F. Supp. 1135, 1048 (S.D. Tex. 1995). (The District Court rejected the SEC’s argument that “the same information could be insufficiently material to require immediate disclosure, yet sufficiently material to require that an insider abstain from trading.”) *Id*.

stock price, 'it follows that the information disclosed...was immaterial as a matter of law.'"[957]

c. Importance Attached to the Information

Courts may satisfy the materiality requirement by looking at the circumstances surrounding the insiders' or their tippees' decisions to trade on the basis of the information in question.[958] This test is applied after concluding that the trader, as a reasonable investor, was convinced to trade on this information because it altered the total mix of information publicly available about the related security.[959] This occurs often when an insider or tippee is in possession of non-public information, and subsequently trades largely and in unusual amounts and volumes in the related security. As a result, the courts may infer that the trader treated the non-public information as material information.[960]

The Second Circuit, in *Texas Gulf Sulphur,* stated that: "a major factor in determining whether the [non-public information] was material is the importance attached to [it] by those who knew about it."[961] In applying this standard, the United States Court of

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[957] *Oran v. Stafford*, 226 F.3d 275, 282 (3rd Cir. 2000). Citing *In re Burlington Coat Factory Securities Litigation, 114 F.3d 1410, 1425 (1997)*. (The Third Circuit quoted from *Burlington* and stated that: "[T]his Court fashioned a special rule for measuring materiality in the context of an efficient securities market. This rule was shaped by the basic economic insight that in an open and developed securities market like the New York Stock Exchange, the price of a company's stock is determined by all available material information regarding the company and its business. In such an efficient market, "information important to reasonable investors ... is immediately incorporated into the stock price." As a result, when a stock is traded in an efficient market, the materiality of disclosed information may be measured post hoc by looking to the movement, in the period immediately following disclosure, of the price of the firm's stock.") *Id*. *See Sauer*, *supra* note 884, at 324. (Richard Sauer, a former Director of the Division of Enforcement at the SEC, found that "[w]hile declining to accept market reaction as the final arbiter of materiality in all instances, the SEC routinely relies on price and volume data as evidence of the importance investors place on a particular disclosure, as do other parties in securities litigation, at least, in the experience of the author, when it serves their interests to do so…Thus, market reaction through changes in stock price and trading volume may be both the best evidence of the materiality of information disclosed.")*Id*.

[958] *See LANGEVOORT, supra* note *6, at* §5:2; *WANG & STEINBERG, supra* note *5, at* 111; *Sauer*, *supra* note 884, at 326.

[959] *LANGEVOORT, supra* note *6, at* §5:2.

[960] *Sauer*, *supra* note 884, at 326. *See* also *Heminway*, *supra* note 887, at 1158.

[961] *SEC. & Texas Gulf Sulphur CO.,*401 F.2d 833, 843, 851. *See Heminway*, at 1158.

Appeals, Seventh Circuit, in *S.E.C. v. Maio*,[962] found that "immediate trading upon receipt of inside information provides evidence of materiality."[963]

In *S.E.C. v. Binette*,[964] the United States District Court for the District of Massachusetts applying the *Texas Gulf Sulphur's* test found that subsequent actions after acquiring confidential information may indicate that the information was sufficiently material.[965]

<u>SEC Provides Examples of Material Information</u>

In the release of Regulation FD, the SEC declined to provide an inclusive or bright-line rule for the purpose of defining the terms "material" and "non-public."[966] However, the SEC asserted that it relied on *TSC's* materiality standard as a general definition of materiality.[967] The SEC acknowledged that the application of the materiality standard can be difficult, but it "has always been understood to encompass the necessary flexibility to fit the circumstances of each case."[968] The SEC, for the purpose of giving more "interpretative guidance" on what information is more likely to be considered material but not per se material, provided the following examples of information:

> (1) earnings information
> (2) mergers, acquisitions, tender offers, joint ventures, or changes in assets
> (3) new products or discoveries, or developments regarding customers or suppliers (e.g., the acquisition or loss of a contract)
> (4) changes in control or in management

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962 51 F.3d 623 (7th Cir. 1995).
963 *Id.* at 637. *See S.E.C. v. Michel*, 521 F.Supp. 2d 795, 826 (N.D. Ill. 2007). (The United States District Court, Northern District of Illinois stated that "[p]erhaps the best evidence of the materiality of the information comes from the conduct of the Defendants themselves.") *Id*. *See WANG & STEINBERG, supra* note *5, at* 112.
964 679 F.Supp. 2d 153 (D. Mass. 2010).
965 *Id.*at 156.
966 SEC. EXCH. COMM'N, RELEASE NO. 7881, Selective Disclosure and Insider Trading, at 9 (Aug. 15, 2000). *See WANG & STEINBERG, supra* note *5, at* 141; *LANGEVOORT, supra* note *6, at* §12:14.
967 *Id.*
968 *Id.*at 9-10. *See LANGEVOORT, supra* note *6, at* §12:14.

(5) change in auditors or auditor notification that the issuer may no longer rely on an auditor's audit report
(6) events regarding the issuer's securities -- e.g., defaults on senior securities, calls of securities for redemption, repurchase plans, stock splits or changes in dividends, changes to the rights of security holders, public or private sales of additional securities
(7) bankruptcies or receiverships.[969]

Non-Public Information[970]

Non-public information can be defined as: "nonpublic facts concerning the business of an issuer, one of its security, or the market for its security, and insofar as the fact relate to the issuer's business, in the usual case are intended to be available only for a corporate purpose and not for the personal benefit of anyone."[971]

Courts and commentators analyzing non-public information in illegal corporate insider trading contexts have noted an overlap between the concepts of non-public and materiality of the information.[972] The Second Circuit observing this notion stated that:

> While the concepts of materiality and nonpublic status refer to different things, there is considerable overlap for purposes of insider trading analysis. The content of a piece of information may be of importance in affecting the share price but so well-known that it does not alter the mix of available information and is therefore not deemed to be material. Conversely, the same information, if previously unknown to the public, may alter substantially the mix of information and thus be deemed very material.[973]

The cornerstone of illegal corporate insider trading liability is the misuse of non-public information for personal gain through trading without disclosure of such

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[969] *Id.*at 10.
[970] Non-public information can be divided into three types: (1) corporate information which is related to an issuer business, such as information relating to the assets or earning's power of the issuer; (2) market information related to the issuer's security that originated outside the issuer, such as tender offers or other forms of mergers and acquisitions; and (3) outside information related to the business of the issuer but received or acquired from outside the issuer. *See* JACOBS, *supra* note 93, at §12:140; *WANG & STEINBERG, supra* note *5, at* 109; *Karmel*, *supra* note 426, at 758-59.
[971] JACOBS, *supra* note 93, at §12:140.
[972] *See LANGEVOORT, supra* note *6, at* §5:4.
[973] *U.S. v. Contorinis,* 692 F.3d 136, 143 (2nd Cir. 2012).

information. If the information is already public, then a corporate insider is legally allowed to trade.[974] The major factor that determines that the information in question is public or non-public is the dissemination of the information to the public and whether the public investors have been given a reasonable time to absorb the information and make their investment decisions on the basis of the new disclosed information.[975]

Although this test may seem easy to comprehend, the application of this test is more complex and complicated.[976] It goes without saying that non-public information becomes public when the issuer discloses the information by filing Form 8-K or/and sending a press release to traditional news services.[977] However, the distinction between public and non-public information can be complicated.[978] Although material, the information is sometime already known to the public through multiple means but not to the general public.[979] For example, the information could be circulated through non-traditional means whether by intentionally leaking the information to the press, reporting the information as rumors or speculative news, or legitimately disclosed to a small number of securities analysts and large institutional investors.[980] Thus, the question is whether this availability of the information makes the information public, and thus an insider is allowed to trade. The SEC and courts have not provided a straightforward answer to this crucial question leaving the

[974] *See* Bradley J. Bondi& Steven D. Lofchie, *The Law of Insider Trading: Legal Theories, Common Defenses, and Best Practices for Ensuring Compliance*, New York University Journal of Law and Business, Vol. 8, 151, 170 (2012).
[975] *Id*; *WANG & STEINBERG, supra* note *5, at* 141; JACOBS, *supra* note 93, at §12:156; *Schipani & Seyhun*, *supra* note 424, at 341.
[976] *See Bondi& Lofchie*, *supra* note 974, at 170; *WANG & STEINBERG, supra* note *5, at* 146.
[977] *Bondi& Lofchie, at 170*; *WANG & STEINBERG, supra* note *5, at* 146 Nt.238.
[978] *See Bondi& Lofchie*, at 170-171; *Sinai*, *supra* note 931, at 758.
[979] *See LANGEVOORT, supra* note *6, at* §5:4; *Bondi& Lofchie*, *supra* note 974, at 170.
[980] *See Id*; *Sinai*, *supra* note 931, at 758.

issue to judicially develop as a question of fact.[981] Courts have provided two theories to answer the question of when the information is public and when an insider is allowed to trade after public disclosure.[982]

The first theory views information as public if it is disseminated to reach the general public through widespread means.[983] The major case that has articulated this theory is *Texas Gulf Sulphur*.[984] In this case, the Second Circuit stated that "[b]efore insiders may act upon material information, such information must have been effectively disclosed in a manner sufficient to insure its availability to the investing public."[985] This theory is favored by the SEC which has repeatedly supported it.[986] In an administrative case, *In the Matters of Investors Management Co*.,[987] the SEC quoted the *Texas Gulf Sulphur's* theory and asserted that: "Information is non-public when it has not been disseminated in a manner making it available to investors generally."[988] In the release notice of Regulation FD, the SEC also quoted this test.[989] The SEC also provided a broad approach to determine the means of how the information became public for the purpose of Regulation FD.[990] It stated that information becomes public by filing or furnishing a Form 8-K, or by disseminating the information through another means that is reasonably designed to provide broad, non-

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[981] *LANGEVOORT, supra* note *6, at* §5:4; *WANG & STEINBERG, supra* note *5, at* 144; *Bondi& Lofchie*, *supra* note 974, at 170.
[982] *Id.*
[983] *WANG & STEINBERG, supra* note *5, at* 143; *Bondi& Lofchie*, *supra* note 974, at 171.
[984] 401 F.2d 833, 843, 854. *See WANG & STEINBERG, supra* note *5, at* 144.
[985] *Id*.
[986] *See WANG & STEINBERG, supra* note *5, at* 144; *Bondi& Lofchie*, *supra* note 974, at 171; *Schipani & Seyhun*, *supra* note 424, at 341; *LANGEVOORT, supra* note *6, at* §5:4. (Professor Donald C. Langevoort suggests that "Caution thus dictates that this is the test to apply in advising whether trading is permissible or not.") *Id.*
[987] 44 S.E.C. 633 (July 29, 1971).
[988] *Id.*at 7.
[989] SEC. EXCH. COMM'N, RELEASE NO. 7881, Selective Disclosure and Insider Trading, at 9 Nt. 40 (Aug. 15, 2000).
[990] *See* Regulation FD, 17 C.F. R. §243.101(e); *Id.*at 14.

exclusionary distribution of the information to the public.[991] For example, non-public information becomes public if it is distributed using a press release through nationwide media news, such as the Wall Street Journal and Reuters Economics Services and Bloomberg.[992]

The question of when the information is absorbed by public investors after disclosure and the insider can legally trade lacks a bright-line answer.[993] The Second Circuit in *Texas Gulf Sulphur* noted that after the public dissemination of public disclosure, there is a "reasonable waiting period" to ensure that the disclosed information has been absorbed and evaluated by public investors.[994] It also noted that: "[W]here the news is of a sort which is not readily translatable into investment action, insiders may not take advantage of their advance opportunity to evaluate the information by acting immediately upon dissemination." The SEC, in turn, has not yet used its rule-making authority to issue a rule determining when corporate insiders and others can trade after the dissemination of non-public information.[995] However, it provides a "fact-oriented approach."[996] The SEC, *In Re Certain Trading in the Common Stock of Faberge, Inc*.,[997] asserted that: "Obviously, what constitutes a reasonable waiting period must be dictated by such surrounding circumstances as the form of dissemination and the complexity of the information, *i.e.*, whether it is 'readily translatable into investment action.'"[998] Therefore, tn most instances,

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[991] *Id*.
[992] *Id. see* JACOBS, *supra* note 93, at §12:156.
[993] *See WANG & STEINBERG, supra* note *5, at* 145; JACOBS, *supra* note 93, at §12:156; COX ET AL, *supra* note 7, at 910.
[994] *SEC. & Texas Gulf Sulphur CO.,*401 F.2d 833, 843, 854 Nt. 18 (2nd Cir. 1968).
[995] *WANG & STEINBERG, supra* note *5, at* 145.
[996] *Id*. *See Bondi& Lofchie*, *supra* note 974, at 172.
[997] *Matter of Certain Trading in the Common Stock of Faberge, Inc.,* 45 S.E.C. 249 (May 25, 1973).
[998] *Id.*at 6. *See* SEC. EXCH. COMM'N, RELEASE NO. 7881, Selective Disclosure and Insider Trading, at 9 Nt. 40 (Aug. 15, 2000).; *WANG & STEINBERG, supra* note *5, at* 145.

the waiting period, therefore, depends on whether and under what circumstances, the public investors have already been aware of the information, and made their investment decisions. A waiting period is not always the same but differs based on the size of the issuer, the content of the information, the trading volume, the price of the security after disclosure, and the means through which the information has reached the general public.[999] In *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith Inc*,[1000] the District Court for the Southern District of New York doubted that "disclosure is instantaneously achieved upon release of the information to the press."[1001] The Court also noted that "It could not be said…that full disclosure had been achieved within two minutes of its release."[1002] Professor Donald C. Langevoort noted that research suggests that a reasonable period can be hours when the disclosure is made by a large issuer that is followed by market professionals and the kind of information is easily assessed.[1003]

The second theory of when information becomes public focuses on whether the information is known legitimately by the investment community in which the price of the related security has already impounded the information even though it is not made available to the general public through widespread channels.[1004] According to the efficient market theory, "if a significant portion of those trading in a certain security have knowledge of the information by any means, the price will reflect that information and deprive the insider of any illegal gains."[1005] This theory has been used by courts and is suggested by

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[999] *See* JACOBS, *supra* note 93, at §12:156; *WANG & STEINBERG, supra* note *5, at* 145.
[1000] *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith Inc.,* 353 F. Supp. 264 (S.D.N.Y. 1972).
[1001] *Id.*at 279.
[1002] *Id*. *See LANGEVOORT, supra* note *6, at* §5:4.
[1003] *LANGEVOORT, supra* note *6, at* §5:4.
[1004] *See WANG & STEINBERG, supra* note *5, at* 148; *LANGEVOORT, supra* note *6, at* §5:4; *Bondi& Lofchie*, *supra* note 974, at 171; COX ET AL, *supra* note 7, at 910.
[1005] *WANG & STEINBERG, supra* note *5, at* 149.

commentators.[1006] The major case that supported this theory is *U.S. v. Libera*.[1007] In this case, the Second Circuit asserted that information can become public even though there is no general public disclosure and only a small number of people know about the information.[1008] The Second Circuit found that: "The issue is not the number of people who possess it but whether their trading has caused the information to be fully impounded into the price of the particular stock. Once the information is fully impounded in price, such information can no longer be misused by trading because no further profit can be made."[1009]

Under this theory, the question of whether the information is public is answered by determining whether the market price of the related security has fully reflected or incorporated the information in question.[1010] Therefore, in *U.S. v. Libera*, the Second Circuit found that the information was non-public because after the public disclosure, the increase in trading volume and price of the security continued after the traditional public disclosure.[1011] As a result, the Second Circuit concluded that: "the jury was correct in

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[1006] *See LANGEVOORT, supra* note *6, at* §5:4. (Professor Donald C. Langevoort finds that: "This approach to defining nonpublic information suggests that information can be "publicly" available even though it has not yet been reported in the press or in a filing with the SEC—and thus not really available to *all* investors… The market approach is indeed theoretically appealing and sound.") Id. *See* also *Bondi& Lofchie*, *supra* note 974, at 171. (The authors suggest that "this second approach, [which is] inspired by the efficient market theory, seems more sophisticated in taking account of new forms of online media and communications.") *Id*.
[1007] *United States v. Libera*, 989 F.2d 596 (2nd Cir. 1993). *See Id.*
[1008] *Id.*at 601.
[1009] *Id*. *See* also, *SEC v. Mayhew* 121 F.3d 44, 50 (2nd Cir. 1997)*; U.S. v. Contorinis, 692 F.3d 136* (2nd Cir. 2012). (The definition of material nonpublic information given in the District Court's instruction was as follows: "If information is available in the public media or in SEC filings, it is public. However, the fact that information has not appeared in a newspaper or other widely available public medium does not alone determine whether the information is nonpublic. Sometimes a corporation is willing to make information available to securities analysts, prospective investors, or members of the press who ask for it even though it may never have appeared in any newspaper publication or other publication. Such information would be public. Accordingly, information is not necessarily nonpublic simply because there has been no formal announcement or because only a few people have been made aware of it." *Id.*at 142. The Second Circuit concluded that "the district court's instructions adequately conveyed the applicable standards.") *Id.*at 144.
[1010] *Libera*, 989 F.2d at 601. *See LANGEVOORT, supra* note *6, at* §5:4; *Bondi& Lofchie*, *supra* note 974, at 171; *WANG & STEINBERG, supra* note *5, at* 148; *Sinai*, *supra* note 931, at 758.
[1011] *Libera*, 989 F.2d at 601

finding that the information was not fully impounded in the price at the time of appellants' trades and was not public for purposes of Section 10(b) prior to the magazine's release."[1012] The waiting period for a corporate insider to wait under this test depends on the period that the market price of the security has been fully incorporated the information.[1013] If the information is already known legitimately by security analysts and other market professionals, then the current traded price of the security will reflect this information even though it is unknown to the general public, and thus, an insider can legally trade.[1014] However, this can be differed based on the size of the issuer and the number of professionals studying such issuer.[1015] In most cases, a large issuer's disclosure of significant information, in contrast to small issuers, takes a shorter time to be absorbed and incorporated into the market security price.[1016]

If, however, the information in question carries more information than what the investment community already knows (e.g., the information is more specific or reliable), courts are more likely to consider the information to be non-public.[1017] The Second Circuit, in *U.S. v. Mylett*,[1018] affirmed the District Court's finding that the information in question

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[1012] *Id.*
[1013] *LANGEVOORT, supra* note *6, at* §5:4; *Bondi& Lofchie*, *supra* note 974, at 171; Cox et al, *supra* note 520, at 910-11; *Sinai*, *supra* note 931, at 758.
[1014] *Id*.
[1015] *See LANGEVOORT, supra* note *6, at* §5:4.
[1016] *Id*. *See WANG & STEINBERG, supra* note *5, at* 150. (The authors reviewed a number of cases where defendants unsuccessfully claimed that at the time of their trading, the security market price had already reflected the value of the information in their hands because the information was already known such as through circulated rumors or speculated reports. The rejection of relying on the efficient market theory by the courts in these cases can be attributed to several points, including (1) the market price has continued to increase after the disclosure which means that the market price did not fully incorporate the value of the new information when the defendant traded; (2) the information was more specific than rumors and the mix of available information at the time of trading; or (3) where the information was acquired improperly.) *Id.*at 150-153.
[1017] *WANG & STEINBERG, supra* note *5, at* 151; *Bondi& Lofchie*, *supra* note 974, at 174.
[1018] 97 F.3d 663 (2nd Cir.1996).

was non-public because although "papers such as the Wall Street journal has speculated" before the public disclosure, the information in question "was both more specific and more certain than any reports in the press."[1019] Also in in *U.S. v. Contorins*, the Second Circuit noted that:

> Insiders often have special access to information about a transaction. Rumors or press reports about the transaction may be circulating but are difficult to evaluate because their source may be unknown. A trier of fact may find that information obtained from a particular insider, even if it mirrors rumors or press reports, is sufficiently more reliable, and, therefore, is material and nonpublic, because the insider tip alters the mix by confirming the rumor or reports.[1020]

In summary, according to the equal access theory, non-public information, which the SEC supports, is information that is not disclosed to the general public through official channels, and the waiting period for insiders before trading is after the general public is aware of the information from widespread media or other recognized general dissemination channels and after they can evaluate the information for the purpose of making their investment decisions. According to the efficient market theory, non-public information is not legitimately in the hands of the investment community and the related traded security has not yet reflected the value of this information. The waiting period for insiders after market professionals and others in the investment community have knowledge of the information in question is until the market price of the related security fully reflects the value of the information in which the insider is unable to gain ill-gotten profits by trading on the basis of such information.

[1019] *Id.*at 666. *See SEC v. Mayhew* 121 F.3d 44, 50 (2nd Cir. 1997). *(*The Second Circuit found that the information in question "effectively confirming information about which there had been speculation and lending a degree of immediacy to it, was nonpublic." *Id.*at 51. *See WANG & STEINBERG, supra* note *5, at* 151; *LANGEVOORT, supra* note *6, at* §5:4.; *Bondi& Lofchie*, *supra* note 974, at 174; *Sinai*, *supra* note 931, at 759.

[1020] *U.S. v. Contorinis,* 692 F.3d 136, 144 (2nd Cir. 2012).

<u>Requisite State of Mind: The Knowing Possession Rule vs. the Actual Use of Material Non-public Information</u>

<u>Overview</u>

A common defense in illegal corporate insider trading cases is that I would have bought or sold anyway; therefore, I did not misuse any information.[1021] The question that arises regarding this issue, however, is whether after being in possession of material non-public information, corporate insiders simply are prohibited from trading until the information becomes public or if they are prohibited solely from using this information for trading. The problem mainly arises when an insider claims that he/she had decided to buy or sell the related security for several reasons before receiving the material non-public information. For example, imagine if a corporate director had decided to sell a substantial number of his/her shares in the corporation to pay a debt, but before selling the shares, the director discovered and possessed material non-public information regarding the corporation. Does the mere possession of the material non-public information prohibit trading? Or does the prohibition not come into play by the sole possession of material non-public unless the decision to trade on that information is the motivation or the reason for the trade? In short, is there a requirement that the possessed material non-public information must be the reason for the trade?

The requisite state of mind is an essential elements of illegal corporate insider trading liability, the requisite state of mind. To prevail in an illegal corporate insider trading case under Rule 10b-5, the plaintiff must demonstrate, among other factors, that the

[1021] *See* Donald C. Langevoort, *What Were They Thinking? Insider Trading and the Scienter Requirement*, Georgetown Public Law Research Paper No. 12-111, at 4 (2013), https://ssrn.com/abstract=2120141.

defendant acted with scienter.[1022] Scienter means "a mental state embracing intent to deceive, manipulate, or defraud."[1023] To suffice this element in a criminal case brought under Rule 10b-5, the plaintiff must show evidence that the defendant, at the time of trading, "willfully" or intentionally violated Rule 10b-5.[1024] In a civil case, the plaintiff is allowed to establish the scienter element by producing evidence showing that the defendant at least acted recklessly.[1025] However, negligent conduct is not enough to establish that the

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[1022] *See LANGEVOORT, supra* note *6, at* §3:13; Stanley Veliotis, *Rule 10B5-1 Trading Plans and Insider's Incentive to Misrepresent*, 47 Am. Bus. L.J. 313, 316 (2010); Carol B. Swanson, Insider Trading Madness: Rule 10b5-1 and the Death of Scienter, 52 U. Kan. L. Rev. 147, 154 (2003); *Langevoort*, *supra* note 621, at 2; *WANG & STEINBERG, supra* note *5, at* 158; J. Kelly Strader, *(Re)concpualizing Insider Trading United States v. Newman and the Intent to Defraud*, 80 Brook. L. Rev. 1419, 1459 (2015).

[1023] *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 Nt.12 (1976).

[1024] *Id.* at 197. ("Section 10(b) makes unlawful the use or employment of 'any manipulative or deceptive device or contrivance' in contravention of Commission rules. The words 'manipulative or deceptive' used in conjunction with 'device or contrivance' strongly suggest that s 10(b) was intended to proscribe knowing or intentional misconduct.") *Id*. In *U.S. v. O'Hagan, 521 U.S. 642, 665(1997*), The Supreme Court stated that "[t]o establish a criminal violation of Rule 10b–5, the Government must prove that a person "willfully" violated the provision." *Id*. Willfulness was defined by the Second Circuit to mean: "in this context '[] a realization on the defendant's part that he was doing a wrongful act under the securities laws.'." *U.S. v. Newman*, 773 F.3d 438,447 Citing *United States v. Cassese*, 428 F.3d 92, 98 (2d Cir.2005). The Dictionary of Meriam Webster defines "willfulness" as "done deliberately: intentional." "willfulness" Merriam-Webster.com, visited on Nov 3, 2018, *available at* https://www.merriam-webster.com/dictionary/willfulness. *U.S. v. Newman*, 773 F.3d 438,447. ([T]o establish willfulness, the Government must 'establish a realization on the defendant's part that he was doing a wrongful act ... under the securities laws' and that such an act 'involve[d] a significant risk of effecting the violation that occurred.'.") *Id*. *See Strader*, *supra* note 1022, at 1446.

[1025] The Supreme Court, in *Ernst & Ernst v. Hochfelder*, rejected to consider whether reckless acts suffice the scienter element. It stated that: "In this opinion the term 'scienter' refers to a mental state embracing intent to deceive, manipulate, or defraud. In certain areas of the law recklessness is considered to be a form of intentional conduct for purposes of imposing liability for some act. We need not address here the question whether, in some circumstances, reckless behavior is sufficient for civil liability under s 10(b) and Rule 10b-5." *Ernst & Erns*, 425 U.S. 185, 193 Nt. 12. The Federal Courts of Appeals concluded that recklessness may satisfy the scienter requirement under Rule 10b-5. *WANG & STEINBERG, supra* note *5, at* 158. (The authors examined the judicial definition of 'recklessness' and concluded that it "has been variously defined by courts, with 'severe' recklessness being the prevailing view.") *Id*. Severe recklessness is defined as "a highly unreasonable omission, involving not merely simple, or even inexcusable negligence, but an extreme departure from the standard of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it." *Id*.at 162 Nt.313 Citing *Hollinger v. Titan Capital Corp*., 914 F.2d 1564, 1569 (9th Cir. 1990) (en banc); *Sundstand Corp. v. Sun Chem. Corp*., 553 F.2d 1033, 1044—1045 (7th Cir.), cert. denied 434 U.S. 875 (1977). The Second Circuit defines recklessness as "conduct which is highly unreasonable and which represents an extreme departure from the standard of ordinary care". *SEC v. Obus,* 693 F.3d 276, 286 Citing *SEC v. McNulty,* 137 F.3d 732, 741 (1998). *See Langevoort*, *supra* note 621, at 3. (Professor Donald C. Langevoort finds that the prevailing view in federal courts is that recklessness suffices scienter requirement. However, Professor Langevoort noted that "recklessness must have a subjective dimension to it, something akin to defendant acted with scienter.[1026] Since material non-public information constitutes one of the essential elements of illegal corporate insider trading liability, the question arise in such cases is how much evidence the plaintiff (e.g., the SEC) must provide to meet the definition of scienter with respect to material non-public information.[1027] To prove scienter, is the plaintiff merely required to show that the defendant traded while in possession of material non-public information (knowing possession rule)? Or must the plaintiff prove the defendant used of this information (actual use rule) by the defendant in his/her trades and the motivation of the trade was the knowledge of this information?[1028]

<u>Judicial Debate</u>

The SEC's opinion was that the mere possession of material non-public information triggers the prohibition of trading until public disclosure occurs.[1029] However, Federal

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conscious or deliberate avoidance of the truth." *Id*. While willfulness requires an intent to defraud the victim and knowing that this intent to defraud is wrongl, recklessness requires that the defendant is aware of facts that his/her acts can be fraudulent or misleading, but he/she disregards these facts and acts anyway.

[1026] *Ernst & Ernst 425 U.S. 185, 202*. (The Supreme Court concluded that "s 10(b) was addressed to practices that involve some element of scienter and cannot be read to impose liability for negligent conduct alone.") *Id*. Negligence means "[T]he failure to exercise the standard of care that a reasonably prudent person would have exercised in a similar situation; any conduct that falls below the legal standard established to protect others against unreasonable risk of harm, except for conduct that is intentionally, wantonly, or willfully disregardful of others' rights; the doing of what a reasonable and prudent person would not do under the particular circumstances, or the failure to do what such a person would do under the circumstances." NEGLIGENCE, Black's Law Dictionary (10th ed. 2014). *See SEC v. Obus,* 693 F.3d 276, 286.

[1027] *See LANGEVOORT, supra* note *6, at* §3:13.

[1028] *Id*; *Swanson*, *supra* note 1022, at 181; *WANG & STEINBERG, supra* note *5, at* 169; *Strader*, *supra* note 1022, at 1446.

[1029] *See id*; *Langevoort*, *supra* note 49, at 1332. The opinion of the SEC was that: "Rule 10b–5 does not require a showing that an insider sold his securities for the purpose of taking advantage of material nonpublic information.... If an insider sells his securities while in possession of material adverse non-public information, such an insider is taking advantage of his position to the detriment of the public." *U.S. v. Teicher*, 987 F.2d 112, 120 (1993) Citing *Sterling Drug Inc. Investigation*, [1978 Transfer Binder] Fed. Sec.L.Rep (CCH), ¶ 81,570, P. 80, 289. *See* also. Donna M. Nagy, *The Possession vs. Use Debate in the Context of Securities Trading by Traditional Insiders: Why Silence can Never Be Golden*, 67 U. Cin. L. Rev. 1129, 1147 (1999); *Sinai*, *supra* note 931, at 758. Many commentators agree with the SEC's "knowing possession" rule because the disclose or abstain rule, basically, requires disclosure of possessed material non-public information from a fiduciary before trading or it prohibits such fiduciary from the trade disregarding whether the fiduciary would use the information or not. In addition, the requirement of scienter in illegal insider trading cases does not nullify the possession test. This is because scienter is related to the defendant's knowledge or awareness

Courts have provided inconsistent opinions regarding this issue.[1030] The Second Circuit, in *U.S. v. Teicher*,[1031] concluded that the "knowing possession" would be sufficient for illegal corporate insider trading conviction.[1032] The Second Circuit affirmed the District Court's jury instruction that: "It is sufficient if the government proves that the defendants purchased or sold securities while knowingly in possession of the material nonpublic information."[1033] In addition, the Court rejected the defendants' citations to cases using the phrase "trading on the basis of" to show that the government must prove a causal connection between the possessed material non-public information and their trades.[1034] The Second Circuit found that these cases "did not address the possibility that the trading was not causally connected to inside information."[1035] The Court endorsed the SEC's "knowing possession" rule based on several factors.[1036] One of these factors is that the phrase "in connection with the purchase or sale of a security" under Rule 10b-5 "must be interpreted flexibly to include deceptive practice 'touching' the purchase or sale of a security."[1037] In addition, the Second Circuit found that as a matter of policy, "a 'knowing possession' standard has the attribute of simplicity. It recognizes that one who trades while knowingly possessing material inside

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of such information as against negligence. The motive is irrelevant to find the intent to defraud. *LANGEVOORT, supra* note *6, at* §3:13. *See Nagy*, *id*. at 1132.

[1030] *See Swanson*, *supra* note 1022, at 181; *WANG & STEINBERG, supra* note *5, at* 169; *LANGEVOORT, supra* note *6, at* §3:13; *Nagy*, *supra* note 1029, at 1137; Allan Horwich, *Possession Versus Use: Is There a Causation Element in the Prohibition on Insider Trading*, 52 Bus. Law. 1235 (1996).

[1031] 987 F.2d 112 (1993).

[1032] *Id.*at 120

[1033] *Id.*at 119.

[1034] *Id.*at 120.

[1035] *Id*.

[1036] *See Id*.

[1037] *Id*.

information has an informational advantage over other traders. Because the advantage is in the form of information… can not lay idle in the human brain."[1038]

The Eleventh Circuit, in *S.E.C. v. Adler*,[1039] refused to apply the "knowing possession" rule and decided that the use test is the "best comports with precedent and Congressional intent, and that mere knowing possession—i.e., proof that an insider traded while in possession of material nonpublic information—is not a *per se* violation."[1040] However, the Eleventh Circuit found that trading while in possession of material non-public information is a strong inference that such information was used by the insider in trading.[1041] "The insider can attempt to rebut the inference by adducing evidence that there was no causal connection between the information and the trade—i.e., that the information was not used. The factfinder would then weigh all of the evidence and make a finding of fact as to whether the inside information was used."[1042] The Court based its decision on the notion that the justification of prohibiting trading on material non-public information is because it gives the insider an unfair advantage.[1043] Such trading is unfair only when its abusive and it is abusive only when it is used.[1044] After reading on the Supreme Courts' precedents, in *Chiarella*, *O'Hagan* and *Dirks*, the court analyzed that the language of these cases suggested that the use of material non-public information is what constitutes a

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[1038] *Id*. at 120-21. (The Second Circuit also state that "As a matter of policy then, a requirement of a causal connection between the information and the trade could frustrate attempts to distinguish between legitimate trades and those conducted in connection with inside information.") *Id*. *See Swanson*, *supra* note 1022, at 181; *WANG & STEINBERG, supra* note *5, at* 176; *LANGEVOORT, supra* note *6, at* §3:13. *See Nagy*, *supra* note 1029, at 1139-1144.
[1039] 137 F.3d 1325 (11th Cir. 1998).
[1040] *Id.*at 1336.
[1041] *Id*.
[1042] *Id*.
[1043] *LANGEVOORT, supra* note *6, at* §3:13. *See Nagy*, *supra* note 1029, at 1139-1140.
[1044] *Id*.

violation of Rule 10b-5.[1045] The Court noted that the Supreme Court found that the justification of prohibiting insider trading on material non-public information is the unfairness of allowing insiders to take advantage of this information without disclosure.[1046] The Supreme Court, in *Dirks,* stated that, in *dicta*: "motivation is not irrelevant to the issue of scienter. It is not enough that an insider's conduct results in harm to investors; rather a violation may be found only where there is 'intentional or willful conduct designed to deceive or defraud investors.'"[1047] Moreover, the Eleventh Circuit rejected the knowing possession rule concluding that this rule is not "limited to situations involving fraud."[1048] Recognizing that the SEC may have a difficult task proving the use of material non-public information, the Court found that it alleviated this difficulty by adopting a rebuttable presumption of use.[1049]

The Ninth Circuit, in *United States v. Smith*,[1050] adopted the use test without a rebuttable presumption of use. The Court concluded that "the weight of authority supports a 'use' requirement…[t]he Supreme Court has consistently suggested, albeit in dictum, that Rule 10b–5 requires that the government prove causation in insider trading prosecutions."[1051] The Ninth Circuit also found that to establish that the defendant acted with scienter, there must be evidence of use of material non-public information rather than

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[1045] *Id.*at 1333. *See WANG & STEINBERG, supra* note *5, at* 172; *Nagy*, at 1140
[1046] *Id.*
[1047] *Id.*at 1334 Citing *Dirks* 463 U.S. at 663 n. 23.
[1048] *Id.*
[1049] *Id.*at 1339. *See LANGEVOORT, supra* note *6, at* §3:13; *WANG & STEINBERG, supra* note *5, at* 172; *Nagy*, *supra* note 1029, at 1138; *Swanson*, *supra* note 1022, at 183.
[1050] 155 F.3d 1051 (9th Cir.1998).
[1051] *Id.*at 1067.

mere possession.[1052] The Court also noted that the knowing possession rule would "go a long way toward making insider trading a strict liability crime."[1053] It stated that:

> Like our colleagues on the Eleventh Circuit, we are concerned that the SEC's "knowing possession" standard would not be—indeed, could not be—strictly limited to those situations actually involving intentional fraud. For instance, an investor who has a preexisting plan to trade, and who carries through with that plan after coming into possession of material nonpublic information, does not intend to defraud or deceive; he simply intends to implement his pre-possession financial strategy.[1054]

The Court concluded that the mere possession of material non-public information without proof of use of this information is insufficient to prove the requisite state of mind for a criminal conviction.[1055] Unlike the Eleventh Circuit's decision, in *Adler*, the Ninth Circuit rejected the presumption of use.[1056] The Court reasoned that: "[W]e deal here with a criminal prosecution, not a civil enforcement proceeding, as was the situation in *Adler*. We are therefore not at liberty, as was the *Adler* court, to establish an evidentiary presumption that gives rise to an inference of use."[1057]

Regarding the SEC's concern about the difficulty of proving the use instead of the mere possession of material non-public information, the Court stated that: "The difficulties, however, are by no means insuperable. It is certainly not necessary that the government present a smoking gun in every insider trading prosecution." For example, there could be a voice recording of the defendant admitting that the trade was because of the possessed

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1052 *Id.*at 1068. *See Nagy*, *supra* note 1029, at 1138.
1053 *U.S. v. Smith*, 155 F.3d 1051, 1068 Nt. 25.
1054 *Id.*at 1068.
1055 *Id.*at 1069.
1056 *Id.*at 1069.
1057 *Id.*at 1069.

material non-public information.[1058] The Court also asserted that circumstantial evidence may prove the use of the information.[1059]

<u>Rule 10b5-1: The Awareness Standard</u>

In the wake of the judicial debate over whether illegal corporate insider trading liability is present from the use of material non-public information or from the mere possession of such information, in 2000, the SEC issued Rule 10b5-1[1060] with the goal of providing clarity and certainty on this crucial matter.[1061]

The SEC noted that in *Adler*, the Eleventh Circuit justified its adoption of the presumption of use standard rather than the mere possession by stating that the Supreme Court used the term "on the basis of" or "on" material non-public information which refers to a preference of use standard even though this issue was not discussed by the Supreme Court.[1062] Therefore, the SEC decided to adopt a new rule that defines the term "on the basis of."[1063] Rule 10b5-1(b) reads:

> (b) Definition of "on the basis of." Subject to the affirmative defenses in paragraph (c) of this section, a purchase or sale of a security of an issuer is "on the basis of" material nonpublic information about that security or issuer if the person making

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[1058] *Id*.

[1059] *Id*. (The Court stated that: "Any number of types of circumstantial evidence might be relevant to the causation issue. Suppose, for instance, that an individual who has never before invested comes into possession of material nonpublic information and the very next day invests a significant sum of money in substantially out-of-the-money call options. We are confident that the government would have little trouble demonstrating 'use' in such a situation, or in other situations in which unique trading patterns or unusually large trading quantities suggest that an investor had used inside information.") *Id*. *See WANG & STEINBERG, supra* note *5, at* 172; *Nagy*, *supra* note 1029, at 1141; *LANGEVOORT, supra* note *6, at* §3:13.

[1060] 17 C.F.R. §240.10b5-1.

[1061] *See SEC Release Notice*, Release No. 7881, *supra* note 423, at 21; *Selective Disclosure and Insider Trading*, *supra* note 218, at 72600; *See WANG & STEINBERG, supra* note *5, at* 181; *LANGEVOORT, supra* note *6, at* §3:14; *Swanson*, *supra* note 1022, at 190; *Horwich*, *supra* note 1030, at 918.

[1062] *S.E.C v. Adler*, 137 F.3d 1325, 1333. (For example, the Court referred to the Supreme Court's description, in *O'Hagan*, of the illegal insider trading conduct as it involves trading "on the basis of material, nonpublic information," which "trading on such information qualifies as a 'deceptive device under § 10(b)." Id.at 1334 Citing *United States v. O'Hagan*, 521 U.S. 642, 117. *See WANG & STEINBERG, supra* note *5, at* 179.

[1063] Selective Disclosure and Insider Trading, 64 Fed. Reg. 72590-01, 72600 (Dec. 28, 1999).

the purchase or sale was aware of the material nonpublic information when the person made the purchase or sale.[1064]

In Rule 10b5-1, the SEC adopted the "awareness" standard which triggers the prohibition of trading on material non-public information when the person making the trade is aware of such information.[1065] However, the SEC declined to define "aware" for the purpose of this rule, but it noted that "aware" is a clear term "a commonly used and well-defined English word, meaning 'having knowledge; conscious; cognizant.'"[1066] Thus, the SEC adopted the "awareness" standard to accomplish two main goals: (1) adopting a closer standard to the "knowing possession" rule to pursue the purpose of illegal corporate insider trading law, "protecting investors and the integrity of securities markets"[1067] by preventing unfair informational advantage; and (2) to avoid the broadness of an absolute "knowing possession" rule, in which it may lead to illegalize trading activities that "a reasonable standard would not make such trading automatically illegal."[1068] This ruling is mostly about a trader who has made a decision to trade before becoming in possession of material non-public information.[1069] In this event, a knowing possession rule would lead to an unwarranted prohibition since the unfair informational advantage is absent in such a scenario.[1070] With respect to the use standard, the SEC found that when someone knows or becomes aware of material non-public information, in most instances, it is highly unlikely that such a person would utterly disregard such knowledge while making a decision to

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1064 17 C.F.R. §240.10b5-1(b).
1065 *Id*; SEC. EXCH. COMM'N, RELEASE NO. 7881, Selective Disclosure and Insider Trading, at 21 (Aug. 15, 2000).
1066 SEC. EXCH. COMM'N, RELEASE NO. 7881, at 22 Nt.105; *Swanson*, *supra* note 1022, at 194.
1067 SEC. EXCH. COMM'N, RELEASE NO. 7881, *id.*
1068 Selective Disclosure and Insider Trading, 64 Fed. Reg., at 72600. *See Horwich*, *supra* note 1030, at 918; *LANGEVOORT, supra* note *6, at* §3:14.
1069 Selective Disclosure and Insider Trading, 64 Fed. Reg., at 72600.
1070 *Id*. *See Swanson*, *supra* note 1022, at 197.

trade.[1071] The SEC stated that: "The awareness standard reflects the common sense notion that a trader who is aware of inside information when making a trading decision inevitably makes use of the information."[1072]

Although the SEC rejected the argument that the adoption of Rule 10b5-1 "awareness" standard was to modify the scienter requirement in illegal corporate insider trading claims,[1073] a number of commentators noted that the "awareness" standard is correctly based on "subjective consciousness" rather than the motivation of the trader and that is what scienter means.[1074] Thus, the SEC may be required to provide evidence demonstrating the state of mind of the trader with respect to the knowledge or awareness of the material non-public information not just the mere possession of it.[1075] "The information was 'not just in the pocket but also in mind'"[1076]

Rule 10b5-1(c)(i) provides three exclusive affirmative defenses to help corporate insiders and others shield themselves from illegal corporate insider trading lability if they comply with one of these affirmative defenses.[1077] The SEC illustrated that "taken as a whole, the affirmative defenses are designed to cover situations, in which a person can

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[1071] Selective Disclosure and Insider Trading, 64 Fed. Reg., at 72600.
[1072] SEC. EXCH. COMM'N, RELEASE NO. 7881, at 22. (The SEC acknowledged that the "awareness" standard would lead to the same results as *Adler's* presumption of use test. However, the SEC suggested that the adoption of the "awareness" standard would help to make the law of illegal corporate insider trading more certain and clearer so that insiders can have straightforward guidelines to comply with the law.) Selective Disclosure and Insider Trading, 64 Fed. Reg., at 72600.
[1073] SEC. EXCH. COMM'N, RELEASE NO. 7881, Selective Disclosure and Insider Trading, at 22 (Aug. 15, 2000).
[1074] *LANGEVOORT, supra* note *6, at* §3:14.
[1075] *Id*; *Horwich*, *supra* note 1030, at 921; *Swanson*, *supra* note 1022, at 197.
[1076] *Swanson*, *supra* note 1022, at 198 citing Tamara Loomis, *Insider Trading; A New SEC Rule is about to Go into Effect*, N.Y. L.J., 5 (2000) (David Levine's, the senior advisor to the SEC's director of enforcement, comments).
[1077] *See WANG & STEINBERG, supra* note *5, at* 182; *LANGEVOORT, supra* note *6, at* §3:14; *Horwich*, *supra* note 1030, at 922.

demonstrate that the material non-public information was not a factor in the trading decision."[1078]

Rule 10b5-1(c)(1)(i) reads:

> (1)(i) Subject to paragraph (c)(1)(ii) of this section, a person's purchase or sale is not "on the basis of" material nonpublic information if the person making the purchase or sale demonstrates that: (A) Before becoming aware of the information, the person had: (1) Entered into a binding contract to purchase or sell the security, (2) Instructed another person to purchase or sell the security for the instructing person's account, or (3) Adopted a written plan for trading securities; (B) The contract, instruction, or plan described in paragraph (c)(1)(i)(A) of this Section: (1) Specified the amount of securities to be purchased or sold and the price at which and the date on which the securities were to be purchased or sold; (2) Included a written formula or algorithm, or computer program, for determining the amount of securities to be purchased or sold and the price at which and the date on which the securities were to be purchased or sold; or (3) Did not permit the person to exercise any subsequent influence over how, when, or whether to effect purchases or sales; provided, in addition, that any other person who, pursuant to the contract, instruction, or plan, did exercise such influence must not have been aware of the material nonpublic information when doing so; and (C) The purchase or sale that occurred was pursuant to the contract, instruction, or plan. A purchase or sale is not "pursuant to a contract, instruction, or plan" if, among other things, the person who entered into the contract, instruction, or plan altered or deviated from the contract, instruction, or plan to purchase or sell securities (whether by changing the amount, price, or timing of the purchase or sale), or entered into or altered a corresponding or hedging transaction or position with respect to those securities.[1079]

Pursuant to Rule 10b5-1(c)(1)(i), corporate insiders and others would not be deemed trading on the basis of material non-public information even though they were aware of such information at the time of trading if before becoming aware of the information, they had entered into a binding contract, instructed another person; or adopted a written plan to purchase or sell the related security.[1080] In addition, this Rule requires corporate insiders and others who claim the availability of one of these defenses to

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1078 SEC. EXCH. COMM'N, RELEASE NO. 7881, at 23.
1079 17 C.F.R. §240.10b5-1(c)(1)(i).
1080 SEC. EXCH. COMM'N, RELEASE NO. 7881, at 21. *See Wang & Steinberg*, *supra* note 139; *Horwich*, *supra* note 1030, at 922; *LANGEVOORT, supra* note *6, at* §3:14.

demonstrate that the binding contract, instruction, or written plan either (1) specified the amount,[1081] price,[1082] and dates of the trades;[1083] (2) adopted a written formula or algorithm for the purpose of determining the amount, price and dates; or (3) did not allow the person, to whom the trading is made to exercise any subsequent influence over how, when, or whether to effect purchases or sales of the related security.[1084] Any other person who had the power to exercise such influence must not be aware of material non-public information at the time of exercising such power.[1085] In addition, Rule 10b5-1(c) requires that the purchase or sale occurred in accordance with the binding contract, instruction, or written plan.[1086] For example if a corporate insider formulated a written plan to trade in his/her corporation's stock in a specified amount and on exacts dates, but at a later date and before executing such trades, the corporate insider changed the written plan to increase or decrease the amount of shares wanted or the dates of trading execution, then such trades would be deemed executed not in compliance with the affirmative defenses under Rule 10b5-1.[1087] Rule 10b5-1(c)(1)(ii) states that these affirmative defenses are available under the condition that the contract, instruction, or plan to purchase or sell the related security "was

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[1081] Rule 10b5-1(c)(1)(iii)(A) defines "Amount" to mean: "either a specified number of shares or other securities or a specified dollar value of securities." 17 C.F.R. §240.10b5-1(c)(1)(iii)(A).
[1082] Rule 10b5-1(c)(1)(iii)(B) defines "Price" to mean: "the market price on a particular date or a limit price, or a particular dollar price." 17 C.F.R. §240.10b5-1(c)(1)(iii)(B).
[1083] Rule 10b5-1(c)(1)(iii)(C) defines "Date" to mean: "in the case of a market order, the specific day of the year on which the order is to be executed (or as soon thereafter as is practicable under ordinary principles of best execution). "Date" means, in the case of a limit order, a day of the year on which the limit order is in force." 17 C.F.R. §240.10b5-1(c)(1)(iii)(C).
[1084] Rule 10b5-1(c)(1)(i)(B),(C). 17 C.F.R. §240.10b5-1(c)(1)(i)(B),(C).
[1085] *Id.*at (B)(3). *See* SEC. EXCH. COMM'N, RELEASE NO. 7881, at 23; Selective Disclosure and Insider Trading, 64 Fed. Reg. 72590-01, 72601 (Dec. 28, 1999).
[1086] Rule 10b5-1(c)(1)(i)(C), 17 C.F.R. §240.10b5-1(c)(1)(i)(C).
[1087] *Id*. *See* SEC. EXCH. COMM'N, RELEASE NO. 7881, at 23; *WANG & STEINBERG, supra* note *5, at* 184.

given or entered into in good faith and not as part of a plan or scheme to evade the prohibitions of this section."[1088]

Rule 10b5-1(c)(2) provides another affirmative defense available only to entities (other than natural persons) where such entity can demonstrate that the purchase or sale of a security was not "on the basis of" material non-public information under two conditions: (1) "The individual making the investment decision on behalf of the [entity] to purchase or sell the securities was not aware of the information;" and (2) the entity "had implanted reasonable policies and procedures…to ensure that individuals making investment decisions would not violate the laws prohibiting trading on material nonpublic information."[1089] Reasonable procedures include Chinese Walls or other informational barriers for the purpose of preventing persons who make the investment decision to purchase or sell the security from being aware of material non-public information that is available to another department inside the entity.[1090] Reasonable procedures also include applying restricted lists preventing the purchase or sale of a security while the entity has material non-public information regarding this security.[1091]

[1088] 17 C.F.R. §240.10b5-1(c)(1)(ii). *See* Selective Disclosure and Insider Trading, 64 Fed. Reg., at 72602. (The SEC asserted that "[t]his requirement is designed to prevent persons from devising schemes to exploit inside information by setting up pre-existing hedged trading programs, and then canceling execution of the unfavorable side of the hedge, while permitting execution of the favorable transaction. By altering the corresponding position, the insider would lose any defense for the transaction that he or she permitted to be executed.") *Id*.

[1089] 17 C.F.R. §240.10b5-1(c)(2)(i),(ii). *See* Id; SEC. EXCH. COMM'N, RELEASE NO. 7881, Selective Disclosure and Insider Trading, at 24 (Aug. 15, 2000). (The SEC asserted that this defense is "derived from the defense against liability codified in Exchange Act Rule 14e-3, regarding insider trading in a tender offer situation." *See Tender Offers*, Release No. 6239, *supra* note 251, at 9-10. (Chinese Walls are "used to isolate the nonpublic flow of information from one department to the rest of the institution.") *Id*. *See WANG & STEINBERG, supra* note *5, at* 184. (The authors define Chinese Walls procedures as "policies and procedures designed to control the flow of material nonpublic information within a multiservice financial firm.") *Id.*at 845.

[1090] Rule 10b5-1(c)(2)(ii), 17 C.F.R. §240.10b5-1(c)(2)(ii). *See* Id.

[1091] *Id*.

Rule 14e-3

The language of Rule 14e-3 expressly states that any person "in possession of material" non-public information relating to a tender offer who knows or has reason to know that it is derived from the bidder or target company is prohibited from trading on such information unless a public disclosure was made first.[1092] Thus, the SEC expressly has adopted the "knowing possession" rule under Rule 14e-3.[1093] Although the SEC did not define "in possession of," one commentator defined this term to be associated with "actual knowledge."[1094] When a person has actual knowledge of such information, he/she is under a duty of inquiry to the information and its source.[1095]

Rule 14e-3 prohibition of trading while in possession of material non-public information related to a tender offer arises when the offeror or the bidder takes substantial steps to commence a tender offer.[1096] This means that the prohibition from trading arises

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[1092] 17 C.F.R. §240.14e-3(a). *See* SEC. EXCH. COMM'N, RELEASE NO. 6239, Tender Offers, at 5 (Sept. 4, 1980). *See supra* note 646-59 and accompanying text.

[1093] Karen Scheon, *Insider Trading: The "Possession Versus Use" Debate*, 184 U. Pa. L. Rev. 239, 259 (1999); *WANG & STEINBERG, supra* note *5, at* 187. *See S.E.C v. Adler*, 137 F.3d 1325, 1339 (9th Cir. 1998).

[1094] JACOBS, *supra* note 860, at 5:40.

[1095] SEC. EXCH. COMM'N, RELEASE NO. 6239, Tender Offers, at 6 Nt. 36; JACOBS, *supra* note 860, at 5:40; *WANG & STEINBERG, supra* note *5, at* 719.

[1096] In the release accompanying the rule, the SEC provided nonexclusive examples of what consists of substantial steps to commence a tender offer. The SEC stated that: "The Commission believes that a substantial step or steps to commence a tender offer include, but are not limited to, voting on a resolution by the offering person's board of directors relating to the tender offer; the formulation of a plan or proposal to make a tender offer by the offering person or the person(s) acting on behalf of the offering person; or activities which substantially facilitate the tender offer such as: arranging financing for a tender offer; preparing or directing or authorizing the preparation of tender offer materials; or authorizing negotiations, negotiating or entering into agreements with any person to act as a dealer manager, soliciting dealer, forwarding agent or depository in connection with the tender offer." SEC. EXCH. COMM'N, RELEASE NO. 6239, Tender Offers, at 6 Nt. 33. In *SEC v. Ginsburg*, 362 F.3d 1292 (11th Cir. 2004), the Second Circuit rejected the defendant's argument that there was not enough evidence to infer that substantial steps had been taken to commence a tender offer as it is required under Rule 14e-3. *Id.*at 1302-03. The Court noted that the activities of the defendant did not "fall into the specifically enumerated examples of activities derived as 'substantial steps' in the SEC release." Id.at 1303. However, it concluded that these examples "are not complete list of 'substantial steps'." *Id*. The Court concluded that: "In this case there was a meeting between executives, which was followed by due diligence procedures, a confidentiality agreement, and by a meeting between Ginsburg and Olds—from which Ginsburg realized that the deal had to go down fast. These activities, which did result in a tender offer, were substantial steps for purposes of Rule 14e–3. Were it otherwise, liability before and after commencing of the tender offer.[1097] The SEC clarified the characteristics of the information and the knowledge about the tender offer under Rule 14e-3.[1098] The SEC stated that the information itself must be (1) non-public;[1099] (2) material;[1100] (3) related to a tender offer; and (4) acquired directly or indirectly from the offeror, the target company, or any other persons working on their behalf as stated under the Rule.[1101] However, a person subject to liability under Rule 14e-3 must know or have reason to know that the information is non-public and derived directly or indirectly from the offeror, the target company, or any other persons working on their behalf as is enumerated under the Rule.[1102] The SEC, however, asserted that in "materiality and relation to a tender, there is no 'knows or has reason to know' standard."[1103]

Some courts have disagreed with the SEC in that Rule 14e-3 does not require the person to know or have reason to know that the information is related to a potential tender offer as against other types of mergers and acquisitions.[1104] The Second Circuit, in *U.S. v.*

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could be avoided by taking care to tip only before the formal steps finalizing the acquisition are completed, leaving a substantial gap between the acquisition of inside information and the regulation of its disbursement." *Id.*at 1304. In *SEC v. Maio,* 51 F.3d 623 (7th Cir. 1995), the Seventh Circuit stated that determination of whether an offeror has taken a substantial step towards commencing its tender offer is to be made on the facts of each case. In this case, the court rejected the defendants' argument that their trading before signing the confidentiality agreement did not violate Rule 14e-3 because it was occurred before the offeror had taken a substantial step to commence the tender offer. The court concluded that a meeting between the chief executives of the two companies was "substantial steps" by the offeror toward commencing its tender offer, noting that, "it is true that the companies had talked about some form of merger for years." *See* JACOBS, *supra* note 860, at §5:40; *WANG & STEINBERG, supra* note *5, at* 718.

1097 *WANG & STEINBERG, supra* note *5, at* 719.

1098 *Tender Offers*, Release No. 6239, *supra* note 251, at 6.

1099 *LANGEVOORT, supra* note *6, at* §7:5. (Professor Donald C. Langevoort suggested that the meaning of non-public information under Rule 14e-3 is the same as the definition of non-public information under Rule 10b-5.) *Id*.

1100 *Id.* (The author suggests that materiality under Rule 14e-3 has the same meaning of materiality under Rule 10b-5.) *Id*.

1101 SEC. EXCH. COMM'N, RELEASE NO. 6239, Tender Offers, at 6 (Sept. 4, 1980).

1102 *Id*.

1103 *Id*. *See* JACOBS, *supra* note 860, at 5:40; *WANG & STEINBERG, supra* note *5, at* 721.

1104 *LANGEVOORT, supra* note *6, at* §7:7. (Professor Donald C. Langevoort argued that "[t]he better approach might be to read the Rule's explicit requirement that the trader know or have reason to know that

Cassese,[1105] affirmed the District Court's decision that in criminal prosecutions under Rule 14e-3, to prove that the defendant acted willfully, the government must prove that the defendant knew that the material non-public information was related to, or most likely was related to a tender offer.[1106]

Rule 14e-3(b) provides an exception from liability to large financial institutions and other entities other than natural persons even when such an entity is in possession of material non-public information related to a tender offer at the time of the trading in the related security.[1107] This exception applies under two conditions: (1) when making the investment decision on behalf of such an entity to purchase or sell the related security or to cause the purchase or sale of the security, the individuals did not know that the information was material non-public information; and (2) the entity had implemented procedures and policies that were reasonable under the circumstances, to ensure that the individuals making the investment decisions regarding the related security would not know it the material non-public information when they made the investment decision.[1108] Such procedures include (a) restricted lists to prevent the purchase or sale of such a security; or (b) Chinese Walls and other information barriers to prevent knowing such information by the individuals who made the investment decisions.[1109]

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the information has been acquired from the bidder, the target, or an associated person to require implicitly that the trader at least be on notice that the source in question was acting in its *status* as bidder, target, or associated person in a tender offer setting.") *Id*. For more discussion about this issue, *see WANG & STEINBERG, supra* note *5, at* 719 Nt.19.

[1105] 428 F.3d 92 (2nd Cir. 2005).

[1106] *Id.*at 97. *See* SEC. EXCH. COMM'N, RELEASE NO. 6239, at 6; PICKHOLZ ET AL, *supra* note 646, at §7:30; *WANG & STEINBERG, supra* note *5, at* 721 Nt. 21.

[1107] Rule 14e-3(b), 17 C.F.R. §240.14e-3(b). SEC. EXCH. COMM'N, RELEASE NO. 6239, at 8.

[1108] *Id*. *See WANG & STEINBERG, supra* note *5, at* 724.

[1109] *Id*.

Summary

Part 3 discusses the U.S. illegal corporate insider trading regulations by focusing on three questions: (1) Who is subject to the prohibition? (2) What does material non-public information mean? and (3) What is the requisite state of mind to violate the prohibition?

While the U.S. illegal corporate insider trading law lacks a statutory provision answering these questions, the discussion of the judicial and administrative developments offers some clarity on the current state of the law. The judicial and administrative developments of the illegal corporate insider trading prohibition under Section 10(b) of the SEA and Rule 10b-5 thereunder reveals that the prohibition of trading on material non-public information goes beyond Section 16 corporate insiders to include any person who has legal access to material non-public information because of a fiduciary-like relationship with the issuer, another party in security transaction (the classical theory), or the source of information (the misappropriation theory). In general, this includes family members, friends, employees, and others entrusted with material non-public information. The prohibition also includes any other person (tippee) who acquires material non-public information directly or indirectly from one of these persons (tipper) when the disclosure is made for personal benefit and the tippee knows or has reason to know that the disclosure was in a breach of the tipper’s fiduciary-like duty of trust and confidence for personal benefit.

The prohibition of trading on material non-public information relating to a tender offer under Rule 14e-3 covers any person in possession of material nonpublic information acquired directly or indirectly from the offeror, the target company, or any person acting on behalf of the offeror or the target company.

Material non-public information is a question of fact and law and it means any information that its disclosure would be considered by a reasonable investor to have significantly changed the total mix of information that is publicly available. This includes information that is probable or certain to occur when the disclosure of such information would have a significant effect on the related security market price. Information is public when it is disclosed through traditional channels that include a filing with the SEC and press statements. Non-public information can be made public if it is available to even a small number of traders when the market price of the related security fully reflects the value of the information.

Courts have inconsistent opinions about whether a proof of mere possession of material non-public information is enough to find illegal corporate insider trading liability or it is required to prove the use of the information. The SEC has offered three affirmative defenses that could shield insiders from liability even if the trade is made while being in possession of material non-public information including when the trade is executed pursuant to a written trading plan before the insider becomes aware of such information.

Once a violation of illegal corporate insider trading is committed, the violator is vulnerable to face several sanctions and penalties. The next part explores the governmental enforcement of illegal corporate insider trading.

Part 4. Governmental Enforcement of Illegal Corporate Insider Trading

Overview

Although Congress has avoided defining illegal corporate insider trading leaving the issue to courts, where most of the parameters of this conduct have been determined, Congress has repeatedly been eager to increase civil penalties and criminal sanctions against illegal corporate insider trading violators. The goal is to ensure that the sanctions deter insiders and others from violating the prohibition of illegal corporate inside trading and to strengthen investors' confidence in the integrity and honesty of securities transactions.[1110]

In 1984, Congress issued the Insider Trading Sanctions Act of 1984 (ITSA) to increase the sanctions and provide new civil penalties that the SEC could seek before federal courts.[1111] This Act granted the SEC the right to seek civil penalties against illegal corporate insider trading violators up to three times the ill-gotten gains or losses they avoided.[1112] It also increased the financial sanctions, under Section 32 of the SEA, from $10,000 to $100,000.[1113] In 1988, Congress again issued the Insider Trading and Securities Fraud Enforcement Act of 1988 (ITSFEA) that added additional civil penalties and increased criminal sanctions against illegal corporate insider trading wrongdoers.[1114] The ITSFEA provided a civil penalty that the SEC could seek against persons who control the

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[1110] *See Schipani & Seyhun*, *supra* note 424, at 355; Nagy, *supra* note 423, at 1366.
[1111] Insider Trading Sanctions Act of 1984 (ITSA), Pub. L. No. 98–376, 98 Stat. 1264, (1984). WILLIAM M. PRIFTI, 24A SECURITIES PUBLIC AND PRIVATE OFFERINGS, § 10:3., Westlaw (database updated by Nov. 2018.), Updated by Joy M. Brayan and Paul Richter.
[1112] ITSA, at §2. This Section is now Section 21A(a) of the SEA. 15 U.S.C.A. § 78u-1(a).
[1113] *Id*. at §3.
[1114] Insider Trading and Securities Fraud Enforcement Act of 1988 (ITSFEA), Pub. L. 100-704, 100 Stat. 4677 (1988). *See Prifti*, *supra* note 1111, §10:4.

violators of the illegal corporate insider trading prohibition.[1115] It also authorized the SEC to award bounties to informants regarding illegal corporate insider trading violations of up to ten percent of the civil penalties recovered.[1116] The ITSFEA also increased criminal sanctions imposed under Section 32 of the SEA.[1117] It increased the maximum fine penalty for natural persons from $100,000 to $1 million and set the maximum fine penalty for entities other than natural persons at $2.5 million.[1118] In addition, it increased the maximum prison sentence from five to ten years.[1119] The ITSFEA also granted an express private cause of action for contemporaneous buyers or sellers to seek damages against insiders who traded with such buyers or sellers.[1120] In 2010, Congress provided the SEC with additional enforcement power that can be used against illegal corporate insider trading violators. Under Section 929P of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank),[1121] Congress granted the SEC the right to impose civil penalties in an administrative action before the SEC's law administrative judges against any person for securities violations including illegal corporate insider trading conducts.[1122]

[1115] ITSFEA, §3. This Section was added to the new Section 21A of the SEA as Section 21A(a)(1)(B). 15 U.S.C.A. § 78u-1(a)(1)(B).
[1116] ITSFEA, §3. This provision was added to Section 21A(e) of the SEA.
[1117] *Id*. §4.
[1118] *Id*.
[1119] *Id*. § 32 of the SEA now imposes a fine penalty of up to $5 million against natural persons and or imprisonment not exceeding 20 years. For entities other than natural persons, the maximum fine is $25 million. 15 U.S.C.A. § 78ff.
[1120] ITSFEA, §5. This section is now Section 20A of the SEA. 15 USCA § 78t-1.
[1121] Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act), Pub. L. 111-203, 124 Stat 1376 (2010).
[1122] *Id*. §929P. This section was added to Section 21B(a) of the SEA. 15 U.S.C.A. § 78u-2. *See* Stephen J. Choi: A. C. Pritchard, *The SEC's Shift to Administrative Proceedings: An Empirical Assessment*, 34 Yale J. on Reg., 5-12 (2017).

It is noteworthy that violations of the prohibition of illegal corporate insider trading essentially impose civil liability since illegal corporate insider trading acts are fraudulent in nature in violation of Section 10(b) of the SEA and Rule 10b-5 promulgated thereunder, as well as Rule 14e-3 regarding trading while in possession of inside information related to a tender offer.[1123] However, Section 32 of the SEA makes such violations or fraudulent activities criminal offenses punishable by severe and extreme penalties.[1124]

The SEC is responsible for enforcing the civil liability of illegal corporate insider trading violations whether through civil litigations or administrative proceedings.[1125] However, criminal enforcement of the illegal corporate insider trading prohibition is referred to the United States Department of Justice (DOJ).[1126] It is common for civil and criminal proceedings to be parallel in that the SEC can file civil suits against illegal corporate insider trading wrongdoers simultaneously when criminal charges have been commenced against the same wrongdoers.[1127] However, not all civil litigation can result in criminal indictments and only a fraction of cases can result in criminal suits.[1128] One of the

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[1123] *See WANG & STEINBERG, supra* note *5, at* 616; *Jacobs*, *supra* note 547, at §20:1.
[1124] *See WANG & STEINBERG, at* 617; *LANGEVOORT, supra* note *6, at* §8:1.
[1125] *See id*; JACOBS, *supra* note 93, at §20:1. *See* also *Newkirk & Robertson*, *supra* note 1.
See U.S. Securities and Exchange Commission, How Investigations Work, https://www.sec.gov/enforce/how-investigations-work.html.
[1126] *Id*. *See* Office of Chief Counsel of Securities and Exchange Commission Division of Enforcement, Enforcement Manual, 5.2., 5.2.1, (November 28, 2017), *available at:* https://www.sec.gov/divisions/enforce/enforcementmanual.pdf.
[1127] *Id*. at 5.2., 52.1. (The Enforcement Manual of the SEC states that "Parallel civil and criminal proceedings are not uncommon. In furtherance of the SEC's mission and as a matter of publicly policy, the staff is encouraged to work cooperatively with criminal authorities, to share information, and to coordinate their investigations with parallel criminal investigations when appropriate.") *Id*. at 5.2.1. *See* HAZEN*, supra* note 2, at §16.24.
[1128] The DOJ's decision whether or not to seek criminal enforcement against illegal corporate insider trading potential wrongdoers or others is guided by the Justice Manual. The United States Department of Justice, Justice Manual, 1-1.200, *available at*: https://www.justice.gov/jm/jm-title-1-organization-and-functions. According to this Manual, the attorney for the government should seek federal prosecution when the attorney "believes that the person's conduct constitute a federal offense, and that the admissible evidence will probably be sufficient to obtain and sustain a conviction; unless (1) the prosecution would serve no substantial federal interest; (2) the person is subject to effective prosecution in another jurisdiction; or (3) there exists an

main differences between civil and criminal liability is that criminal liability under Section 32 of the SEA requires that the prosecution show that the alleged violation is committed willfully.[1129] To prove that the defendant acted willfully in addition to other elements of an illegal corporate insider trading violation, the prosecution must present enough evidence that demonstrates the elements beyond a reasonable doubt.[1130] In contrast, civil liability does not require that the prosecution proves willfulness of the defendant[1131] and can be sustained based on the preponderance of evidence.[1132] Therefore, since civil liability requires a lower standard of proof, making it easier to uphold, the likelihood of civil litigation is far higher than criminal proceedings.[1133]

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adequate non-criminal alternative to prosecution." *Id*. at 9-27.220. *See LANGEVOORT, supra* note *6, at* §8:1. (Professor Langevoort indicates that parallel criminal prosecution against illegal corporate insider trading wrongdoers is estimated to be around 20% of illegal insider trading cases. *Id*. *See Criminal Prosecutorial Discretion in Insider Trading Cases: Let's Look At the Numbers*, 2, *available at*: https://www.nysba.org/Sections/Commercial_Federal_Litigation/ComFed_Display_Tabs/Reports/CRIMINALPROSECUTORIALDISCRETIONINTHEINSIDERTRADINGCASES_pdf.html. (This study shows that the DOJ sought criminal prosecution against 65 out of 159 potential illegal corporate insider trading violators for whom the SEC filed civil suits in the New York Federal Courts from 2004 to 2010.) *Id*. Roberta S. Karmel reported that the SEC prosecuted more than 590 defendants from 2010 to 2015 in civil illegal corporate insider trading cases. *Karmel*, *supra* note 426, at 757. The SEC Enforcement Annual Report of 2018 reports that the SEC took 51 enforcement civil actions against illegal corporate insider trading violations which equals 6% of SEC's total enforcement actions. U.S. Securities and Exchange Commission, Annual Report Divison of Enforcement 2018, 14 (Nov 2, 2018), *available at*: https://www.sec.gov/files/enforcement-annual-report-2018.pdf. *See Langevoort*, *supra* note 49, at 1331. (Professor Donald Langevoort has found that "supporting insider trading enforcement as a priority, then, became a way of signaling one's commitment to the commission's identity." *Id*.

[1129] *See* 15 U.S.C.A. § 78ff; *Strader*, *supra* note 1022, at 1445-46; *WANG & STEINBERG, supra* note *5, at* 620. *See U.S. v. O'Hagan*, 139 F.3d 641, 647 (1998). (The Ninth Circuit stated that: "we think it is clear that the Supreme Court was simply explaining that the statute provides that a negligent or reckless violation of the securities law cannot result in criminal liability; instead, the defendant must act willfully…'willfully' simply requires the intentional doing of the wrongful acts") *Id*. *See* also *supra* note 600.

[1130] *Newman*, 773 F.3d 438, at 451. *See Strader*, *supra* note 1022, at 1466. For more information about the standard of proof in criminal proceedings, *see* Broun Kenneth S. et al, *Evidence*, §341, 724-25 (7th ed. 2014).

[1131] However, it is required to prove that the defendant acted at least with recklessness. *See supra* note 1022-28 and accompanying text.

[1132] *See SEC v. Ginsburg*, 362 F.3d 1292,1298 (11th Cir. 2004); JACOBS, *supra* note 93, at §21:23; *Kenneth*, *supra* note 705, §339, 720-21.

[1133] *See supra* note 1128.

This part seeks to determine the elements of illegal corporate insider trading violations. Then it discusses the standard of proof and admissible evidence. It finishes by describing the usual civil and criminal penalties available after a conviction or liability is found.

Elements of Illegal Corporate Insider Trading Liability

Illegal corporate insider trading liability that is actionable under Section 10(b) of the SEA and Rule 10b-5, promulgated thereunder, requires the existence of requisites or elements of fraudulent conduct that is prohibited under the provision. This involves deception in connection with the purchase or sale of a security.[1134] In an illegal corporate insider trading context, fulfillment of these elements is sustained if the trading conduct involves silence or nondisclosure of material non-public information of which the trader is aware and has a duty to disclose but fails to do so.[1135] To prevail in an illegal corporate insider trading lawsuit, federal courts require the demonstration of a purchase or sale of a security on the basis of material non-public information in a breach of a duty of trust and confidence, with scienter.[1136] These two elements are discussed below.

[1134] *See U.S. v. Smith*, 155 F.3d. 1051, 1063 (9th Cir. 1998). Courts define the phrase "in connection with" flexibly to include prohibited conduct such as "touching" the purchase or sale of a security. U.S. v. *Teicher*, 987 F.2d 112, 120 (2nd Cir. 1993). Citing *Superintendent of Insurance,* 404 U.S. 6, 12. *WANG & STEINBERG, supra* note *5, at* 199.
[1135] *Id*.
[1136] *See*. *S.E.C. v. Fox,* 654 F. Supp. 781, 789–90 (N.D. Tex. 1986). (The Northern District of Texas stated that "By alleging that the defendants traded on material inside information, plaintiff must prove the following: (1) that the defendants were insiders; (2) that the information in defendants' possession was material; (3) that the defendants had a duty to disclose the alleged information or to abstain from trading; and (4) that the defendants acted with scienter.") *Id*.

a. **Purchase or Sale of a Security on the Basis of Material Non-public Information in a Breach of a Duty of Trust or Confidence.**

This element covers the *actus reus* of illegal corporate insider trading activity where the defendant commits the prohibited conduct, which is the purchase or sale of a security on the basis of material non-public information without disclosure of such information in violation of a duty to disclose, which arises from a duty of trust and confidence.[1137] The requirement of purchasing or selling a security means that refraining from purchasing or selling a security on the basis of material non-public information is not prohibited conduct.[1138] In addition, the purchase or sale must be on the basis of material non-public information that is unknown to the public and has not been disclosed. A reasonable investor would also consider that the information, if disclosed, would have significantly altered the total mix of information available.[1139] Furthermore, the purchase or sale must be in a breach of a duty of trust and confidence, whether the trade is committed by classic corporate insiders, or misappropriators, or derivatively by tippees who inherit the duty of trust and

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[1137] *See Salman v. U.S.*, 137 S. Ct. 420, 423 (U.S. 2016). (The Supreme Court stated that: "Section 10(b) of the Securities Exchange Act of 1934 and the Securities and Exchange Commission's Rule 10b–5 prohibit undisclosed trading on inside corporate information by individuals who are under a duty of trust and confidence that prohibits them from secretly using such information for their personal advantage… Individuals under this duty may face criminal and civil liability for trading on inside information (unless they make appropriate disclosures ahead of time.") *Id*. Rule 10b5-1(a), 17 C.F.R. §240.10b5-1(a). ("The 'manipulative and deceptive devices' prohibited by Section 10(b) of the Act (15 U.S.C. 78j) and §240.10b-5 thereunder include, among other things, the purchase or sale of a security of any issuer, on the basis of material nonpublic information about that security or the issuer, in breach of a duty of trust or confidence that is owed directly, indirectly, or derivatively, to the issuer of that security or the shareholders of that issuer, or to any other person who is the source of the material nonpublic information.") *Id*. *See* also *Strader*, *supra* note 1022, at 1464.

[1138] *See WANG & STEINBERG, supra* note *5, at* 208. (The authors state that the "decision not to trade would almost certainly not violate Rule 10b-5." This is because it is not "conduct 'in connection with' the purchase or sale of a security." *Id*. Courts define the phrase "in connection with" flexibly to include prohibited conducts "touching" the purchase or sale of a security. U.S. v. *Teicher*, 987 F.2d 112, 120 (2nd Cir. 1993). Citing *Superintendent of Insurance,* 404 U.S. 6, 12.

[1139] *See Salman v. U.S.*, 137 S. Ct. at 423. For more information about the definition of material non-public information, *see supra* notes 801-1021 and accompanying text.

confidence from the disclosing insider.[1140] If the defendant is a classic insider, he/she commits illegal corporate insider trading through the purchase or sale of his/her corporation's security without disclosure of material nom-public information in a breach of the insider's fiduciary duty owed to the corporation's shareholders.[1141] Under the misappropriation theory, the defendant commits the illegal trade by purchasing or selling a security on the basis of material non-public information in a breach of his/her duty of trust and confidence owed not to the party who trades with but to the source of the information.[1142] Furthermore, since tippees assume a duty of trust and confidence derivatively from the tipper, their purchase or sale is in a breach of such a duty when the disclosure is in a breach of the tipper's fiduciary duty.[1143]

b. With Scienter

This element is about the *mens rea* of the prohibited conduct of the illegal corporate insider trading.[1144] Courts define scienter as "a mental state embracing intent to deceive, manipulate, or defraud."[1145] To suffice the element of scienter, the insider must intentionally commit trading on the basis of material non-public information in a breach of a duty of trust and confidence.[1146] This requirement means that a standard lower than

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[1140] *See supra* note 1137. *See* S.*E.C. v. Obus,* 693 F.3d 276, 284 (2nd Cir. 2012).
[1141] *Chiarella*, 445 U.S. at 235; *U.S. v. United States v. Smith,* 155 F.3d 1051, 1064 (9th Cir. 1998); *Obus*, *id*.
[1142] *O'Hagan*, 521 U.S., at 652; *id*. *See* also *WANG & STEINBERG, supra* note *5, at* 192.
[1143] *Salman v. U.S*., 137 S. Ct. at 423; *United States v. Newman*, 773 F.3d 438, 446 (2nd Cir. 2014); *Obus,* 693 F.3d at 284. *See supra* notes 774-84 and accompanying test.
[1144] *See Strader*, *supra* note 1022, at 1460; *WANG & STEINBERG, supra* note *5, at* 164.
[1145] *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 Nt.12 (1976). *See supra* notes 1022-28 and accompanying text. *See* also *Langevoort*, *supra* note 597, at 3.
[1146] *U.S. v. O'Hagan,* 521 U.S. 642, 665-66 (1997*)*. (The Supreme Court stated that: "[W]e emphasize…two sturdy safeguards Congress has provided regarding scienter. To establish a criminal violation of Rule 10b–5, the Government must prove that a person 'willfully' violated the provision. Furthermore, a defendant may not be imprisoned for violating Rule 10b–5 if he proves that he had no knowledge of the Rule.") *Id*. *O'Hagan*, 139 F.3d. at 647. (The Ninth Circuit stated that: "we think it is clear that the Supreme Court was simply explaining that the statute provides that a negligent or reckless violation of the securities law cannot result in criminal liability; instead, the defendant must act willfully…'[W]illfully' simply requires the intentional

deliberate and willful intent of committing the prohibited conduct does not suffice to sustain a conviction in a criminal suit.[1147] Courts define willfulness as "a realization on the defendant's part that he was doing a wrongful act under the securities laws' and that such an act 'involved a significant risk of effecting the violation that occurred'."[1148] However, in civil proceedings, the element of scienter may suffice if the defendant acts recklessly.[1149] The Second Circuit has defined the standard of recklessness as a "conduct which highly unreasonable and which represents an extreme departure from the standard of ordinary care."[1150]

To establish the element of scienter for an insider defendant, courts require that the insider must purchase or sell a security while having actual knowledge, or being reckless in not knowing in regard to civil liability, of possessed material non-public information.[1151]

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doing of the wrongful acts" The Eighth Circuit illustrated that to establish willfulness, it is not required to show that the defendant knew that his act was in violation of the law since the general rule says "ignorance of the law or a mistake of law is no defense to criminal prosecution.'." The Court also stated that, although some laws require knowledge that the conduct is in violation of the law, this rule does not apply to §32 of the SEA criminal conviction "for violation of rules and regulations implementing §10(b) necessarily involves fraudulent conduct and breaches of duty by the defendant. Such acts do not involve conduct that is often innocently undertaken." *Id*. Willfulness was defined by the Second Circuit to mean: "in this context '[] a realization on the defendant's part that he was doing a wrongful act under the securities laws.'. and that such an act 'involved a significant risk of effecting the violation that occurred.'." *U.S. v. Newman*, 773 F.3d. at 447. *See WANG & STEINBERG, supra* note *5, at* 159; *see LANGEVOORT, supra* note *6, at* §8:13. (Professor Donald C. Langevoort states that: "in a case based on the misappropriation theory, for example, it would be enough that the defendant was aware that what he was doing was prohibited by (or contrary to the interests of) his employer. Given the emphasis in Chiarella and Dirks on the intent to benefit and breach of fiduciary duty elements for establishing a violation in the first place, nearly all violations of the abstain or disclose rule should provide a basis for criminal prosecution under this approach.") *Id*. *See* also *supra* note 1025 and accompanying text.

[1147] *Id*.

[1148] *Newman*, 773 F.3d at 447. *See WANG & STEINBERG, supra* note *5, at* 615.

[1149] *Wang & Steinberg*, at 159. *See supra* notes 1025-26 and accompanying text.

[1150] *Obus*, 693 F.3d. 276, 286 (2nd Cir. 2012). (The Second Circuit stated that: "we have held that scienter 'may be established through a showing of reckless disregard for the truth, that is, conduct which is highly unreasonable and which represents an extreme departure from the standards of ordinary care,'.") *Id*. Citing SEC. v. McNulty, 137 F.3d. at 741. *See id*.

[1151] *U.S. v. Rajaratnam*, 719 F.3d 139, 159 (2nd Cir. 2013). (The Second Circuit asserted that: "[i]t is sufficient if the government proves that the defendant [ ] purchased or sold securities while knowingly in possession of the material nonpublic information,'") *Id*. Citing *Teicher,* 987 F.2d. at 119; *Obus*, 693 F.3d. at 286; *See WANG & STEINBERG, supra* note *5, at* 164. *See supra* notes 1072-76 and accompanying text. However, To suffice the element of scienter for the insider tipper, the insider must intentionally and deliberately, or recklessly in civil proceeding, tip another person material non-public information in a breach of the insider's duty of trust and confidence for personal benefit.[1152] The tipper must have knowledge that the tip would be used for securities trading.[1153] The tippee's scienter is established by showing that the tippee has knowledge that the insider has tipped information that is material and non-public disclosed in a breach of the tipper's duty of trust and confidence for personal benefit, and he/she still uses this information to trade or tip others for personal benefit.[1154]

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some courts require not only that the defendant trades knowing that he/she has material non-public information, but also must use the information. This means that the knowledge of material non-public information is the cause of the trade. For more information *see supra* notes 1029-59 and accompanying text. Although the SEC denied that the Rule 10b5-1awarness standard was a modification of the element of scienter, many scholars have suggested otherwise. *See supra* note 1072-76 and accompanying text.

[1152] *Obus*, 693 F.3d. at 286. (The Second Circuit stated that: "the tipper must tip deliberately or recklessly, not through negligence. Second, the tipper must know that the information that is the subject of the tip is non-public and is material for securities trading purposes or act with reckless disregard of the nature of the information. Third, the tipper must know (or be reckless in not knowing) that to disseminate the information would violate a fiduciary duty." *Id*. The Second Circuit stated that "there is a valid defense to scienter if the tipper can show that he believed in good faith that the information disclosed to the tippee would not be used for trading purposes." *Id*. at 287. The Second Circuit also found that there is no bright line between a negligent tip and reckless tip. However, it stated that it does not required that a tipper needs to know for certain that the tippee would trade. Conscious avoidance and willful blindness can be sufficient to establish tipper scienter.") *Id*. *See Salman v. U.S.*, 137 S. Ct. 420, 423 (U.S. 2016). *WANG & STEINBERG, supra* note *5, at* 167; *Strader*, *supra* note 1022, at 1465-72. *See* also *supra* notes 774-826 and accompanying text.

[1153] *Salman v. U.S.*, 137 S. Ct. at 427. (The government asserted that "in order to establish a defendant's criminal liability as a tippee, it must prove beyond a reasonable doubt that the tipper expected that the information being disclosed would be used in securities trading. *Id*. The Supreme Court also found that: "by disclosing confidential information as a gift to his brother with the expectation that he would trade on it, Maher breached his duty of trust and confidence to Citigroup and its clients.") *Id*. *see supra* note 756-58 and accompanying text.

[1154] *United States v. Newman*, 773 F.3d 438, 450 (2nd Cir. 2014). ("In sum, we hold that to sustain an insider trading conviction against a tippee, the Government must prove each of the following elements beyond a reasonable doubt: that (1) the corporate insider was entrusted with a fiduciary duty; (2) the corporate insider breached his fiduciary duty by (a) disclosing confidential information to a tippee (b) in exchange for a personal benefit; (3) the tippee knew of the tipper's breach, that is, he knew the information was confidential and divulged for personal benefit; and (4) the tippee still used that information to trade in a security or tip another individual for personal benefit.") *Obus*, 693 F.3d. at 289. (The second Circuit stated that "To summarize our discussion of tipping liability, we hold that tipper liability requires that (1) the tipper had a duty to keep material non-public information confidential; (2) the tipper breached that duty by intentionally or recklessly relaying the information to a tippee who could use the information in connection with securities trading; and (3) the tipper received a personal benefit from the tip. Tippee liability requires that (1) the tipper breached a duty by tipping confidential information; (2) the tippee knew or had reason to know that the tippee

In regard to the element of liability under Rule 14e-3, the elements are as follows: (1) when any person has taken a substantial step to commence or has commenced a tender offer; (2) another person purchases, sells, or causes the purchase or sale of any security of the issuer (the target of the tender offer) in possession of material non-public information related to such tender offer; (3) with scienter.[1155] The other person knows or has reason to know such information is non-public, and has been acquired directly or indirectly from the offering person, from the issuer, or anyone acting on behalf of the offeror or the issuer.[1156] The SEC does not require that the trader knows that the information is material or related to a tender offer as to be distinguished from other types of corporate acquisitions or the trade is in breach of fiduciary duty.[1157] However, in criminal proceedings, the Second Circuit, in *U.S. v. Cassese*,[1158] affirmed the District Court's decision that to prove the willfulness standard in criminal prosecutions under Rule 14e-3, the government must prove that the defendant knew that the material non-public information related to, or most likely related to, a tender offer.[1159] In addition, the elements of improper tipping of material non-public information related to a tender offer are as follows: (1) after any person has taken a substantial step to commence or has commenced a tender offer; (2) the offeror or the target

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improperly obtained the information (*i.e.*, that the information was obtained through the tipper's breach); and (3) the tippee, while in knowing possession of the material non-public information, used the information by trading or by tipping for his own benefit.") *Id*. *Salman v. U.S.*, 137 S. Ct. at 427. (The Supreme Court referred to the Government statement that "in order to establish a defendant's criminal liability as a tippee, it must prove beyond a reasonable doubt that the tipper expected that the information being disclosed would be used in securities trading…The Government also notes that, to establish a defendant's criminal liability as a tippee, it must prove that the tippee knew that the tipper breached a duty—in other words, that the tippee knew that the tipper disclosed the information for a personal benefit and that the tipper expected trading to ensue.") *Id. see supra* notes 817-26 and accompanying text.

[1155] SEC. EXCH. COMM'N, RELEASE NO. 6239, Tender Offers, at 6 (Sept. 4, 1980).

[1156] *Id; See* JACOBS, *supra* note 860, at §5:40; *LANGEVOORT, supra* note *6, at* §7:9.

[1157] *See United States v Chestman*, 947 F.2d 551, 571 (2nd Cir. 1991). *See supra* note 652 and accompanying text.

[1158] 428 F.3d.92, 97 (2nd Cir. 2005).

[1159] *Id. See*. *See supra* notes 1096-109 and accompanying text.

company or anyone acting on their behalf tips material nonpublic information related to a tender offer; (3) to any other person under circumstances in which it is reasonably foreseeable that such communication is likely that such a person will trade; and (4) with scienter.[1160] Here there is no requirement of a breach of fiduciary duty or gaining personal benefit from the improper disclosure.[1161] The tippee only needs to know that the information was disclosed by an insider either directly or indirectly and the information is non-public.[1162] However, in criminal prosecutions, the tippee must know that the purchase or sale is related to a tender offer and it is material non-public information.[1163]

Evidence in Illegal Corporate Insider Trading Proceedings

The question of whether presented evidence in illegal corporate insider trading proceedings is enough or sufficient to prove a conclusion of liability is one of the most difficult questions that courts have to face.[1164] This is because the evidence must demonstrate that the insider has traded while subjectively being aware of material non-public information, or the evidence must show that the insider intentionally has tipped an outsider such information for personal benefit. In addition, the evidence must prove the other elements of the prohibited conduct.[1165] However, due to the complexity and unmitigated trading volume of securities transactions in impersonal markets along with abundant modern online social apps and blogs, it has become more difficult to detect and investigate illegal corporate insider trading activities especially when suspected traders

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[1160] Rule 14e-3(d)(1), 17 C.F.R. §240.14e-3(d)(1). *See* JACOBS, *supra* note 860, at §5:40; *Hazen*, *supra* note 7, at §12:168. *See supra* note 437-46 and accompanying text.
[1161] *Id*.
[1162] SEC. EXCH. COMM'N, RELEASE NO. 6239, Tender Offers, at 6 (Sept. 4, 1980); *Id*.
[1163] HAZEN*, supra* note 2, at §12:168.
[1164] NAGY ET AL, *supra* note 84*,* at 548.
[1165] *Id*; *Langevoort*, *supra* note 597, at 5.

allege that the trade was based on an innocent bases, such as rumors or speculative news.[1166] Courts have stated that the SEC, in civil proceedings, and the DOJ, in criminal proceedings, need to prove the elements of prohibited conduct of illegal corporate insider trading prohibited conduct using direct or circumstantial evidence.[1167] Courts have allowed the use of circumstantial evidence because they have recognized that direct evidence is not usually available due to the secrecy of trading on inside information and the difficulty of finding "a smoking gun" that directly proves the commitment of an illegal trade.[1168] However, courts require that represented evidence must corroborate the alleged facts and demonstrate the elements of the illegal conduct and it shall not be based on conjecture and speculation.[1169] It is noteworthy that the standard of proof in criminal proceeding is that

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[1166] *See* The Future of White Collar Enforcement: A prosecutor's View Prepared Remarks of U.S. Attorney Preet Harara New York City Bar Association, The United States Attorney's Office, Southern District of New York, (Oct 20, 2010) *available at*: https://www.justice.gov/usao-sdny/speech/future-white-collar-enforcement-prosecutor-s-view-prepared-remarks-us-attorney.

[1167] *Securities and Exchange Commission v. Sabrdaran*, 252 F.Supp. 3d 866, 878 (N.D. Cal. 2017). (The District Court of Northern District of California rejected the defendants' argument that no direct evidence proved sharing of a tip, stating that: "direct evidence is not necessary. 'Direct evidence of insider trading is, indeed, rare; and the SEC is entitled to prove its case through circumstantial evidence.' But it 'may not base insider trading actions on strained inferences and speculation.' In meeting its burden, the SEC must identify the facts'." *Id*. *SEC v. Ginsburg*, 362 F.3d 1292, 1298 (11th Cir. 2004). (The Eleventh Circuit, in civil proceeding, stated that: "The SEC must prove violations of § 10(b) and § 14(e), and their supplementary Rules, by a preponderance of the evidence, and may use direct or circumstantial evidence to do so. 'Circumstantial evidence has no less weight than direct evidence as long as it reasonably establishes that fact rather than anything else.'.") *Id*. *United States v. Newman*, 773 F.3d 438, 451 (2nd Cir. 2014). (The Second Circuit, in criminal proceeding stated that to conclude judgment of conviction, "no distinction between direct and circumstantial evidence. The Government is entitled to prove its case solely through circumstantial evidence, provided, of course, that the Government still demonstrates each element of the charged offense beyond a reasonable doubt… However, if the evidence 'is nonexistent or so meager,' such that it 'gives equal or nearly equal circumstantial support to a theory of guilt and a theory of innocence, then a reasonable jury must necessarily entertain a reasonable doubt,'." *Id*. Citing *Cassese*, 428 F.3d at 99.

[1168] *Nagy et al*, *supra* note 84, at 548; *Id*. Circumstantial evidence means: "Evidence based on inference and not on personal knowledge or observation." It is defined also as "all evidence that is not given by eyewitness testimony." Evidence, Black's Law Dictionary (10th ed. 2014). Direct evidence is defined as "evidence that is based on personal knowledge or observation and that, if true, proves a fact without inference or presumption." *Id*.

[1169] *S.E.C. v. Evans*, Not Reported in F.Supp.2d, 4 (D. Or. 2006). (The Distract Court of District of Oregon stated that: "the SEC may not base insider trading actions on strained inferences and speculations.") *Id*. *See supra* note 1154. *See* also *LANGEVOORT, supra* note *6, at* §3:13.

the DOJ must prove the elements of the illegal corporate insider trading liability beyond a reasonable doubt either through the use of direct or circumstantial evidence.[1170] The standard of beyond a reasonable doubt is if the presented evidence "gives equal or nearly equal circumstantial support to a theory of innocence as a theory of guilt, that evidence necessarily fails to establish guilt beyond a reasonable doubt."[1171] However, in civil proceedings, the accepted standard of proof is the preponderance of evidence.[1172] The preponderance of evidence standard means that "the greater weight of the evidence…that has the most convincing force; superior evidentiary weight, though not sufficient to free the mind wholly from all reasonable doubt, is still sufficient to incline a fair and impartial mind to one side of the issue rather than the other."[1173]

Illegal corporate insider trading activities are detected by the SEC's Enforcement Division, which is also responsible for investigating and seeking civil proceedings against violators using several sources.[1174] These sources include referrals from self-regulatory organizations, such as the Financial Industrial Regulatory Authority (FINRA).[1175]

[1170] *Newman*, 773 F.3d. at 451.
[1171] *Newman*, at 455. *See* SIMON M. LORNE AND JOY MARLENE BRYAN, 11 ACQUISITIONS & MERGERS, §1:29.40, Westlaw (database updated by November 2018). The standard of "beyond a reasonable doubt" "is the standard used by a jury to determine whether a criminal defendant is guilty. In deciding whether guilt has been proved beyond a reasonable doubt, the jury must begin with the presumption that the defendant is innocent." Reasonable Doubt, Black's Law Dictionary (10th ed. 2014).
[1172] *Evans*, Not Reported in F.Supp.2d, at 4. (The District Court of District of Oregon stated that: "The standard of proof in a civil case is preponderance of the evidence, and this standard applies even where the SEC bases its case on circumstantial evidence.") *Id*. *Ginsburg*, 362 F.3d, at 1298. (The Eleventh Circuit stated that: "The SEC must prove violations of § 10(b) and § 14(e), and their supplementary Rules, by a preponderance of the evidence.") *Id*. *See* Hervé Gouraige, *Do Federal Courts Have Constitutional Authority to Adjudicate Criminal Insider-Trading Cases?* 69 Rutgers U.L. Rev. 47, 83 Nt. 159 (2016).
[1173] Black's Law Dictionary (10th ed. 2014). ("This is the burden of proof in most civil trials, in which the jury is instructed to find for the party that, on the whole, has the stronger evidence, however slight the edge may be.") *Id*.
[1174] *See* Chair Mary Jo White, Remarks at the Securities Enforcement Forum, (Oct 9, 2013) [White], *available at*: https://www.sec.gov/news/speech/spch100913mjw; *How Investigations Work*, *supra* note 1125; Andrew Van Osselaer, *Insider Trading Enforcement & Link Prediction*, Texas Law Review, Vol. 96:399,400,02 (2017).
[1175] *Id*.

Resources also include whistleblowers, investors' complaints, and media reports.[1176] In addition to these traditional sources of detection, the Enforcement Division detects illegal corporate insider trading transactions through an in-house-developed market analysis system,[1177] called the Advanced Bluesheet Analysis Program (ABAP).[1178] The ABAP has helped the Enforcement Division not only detect suspicious trading activities before major events, but also detect other correlated trades, revealing the relationship between multiple traders that may not be noticed.[1179] After detecting a potential violation of the illegal insider prohibition, the Enforcement Division goes on to build more facts about the case through an informal investigation by interviewing voluntary witnesses and reviewing brokerage records and trading data.[1180] The Enforcement Division may decide to proceed to a formal investigation after getting a formal order from the SEC, where the Division has the power to subpoena witnesses and require the production of records and other necessary orders to investigate the violation.[1181] While doing the investigation, the Enforcement Division focuses on finding facts that are related to proving the elements of illegal corporate insider trading liability.[1182] This includes possession of material non-public information at the time of the trade, and finding scienter.[1183] Sometimes, the Enforcement Division may also seek

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[1176] *Id*.
[1177] *See Osselaer*, at 406.
[1178] *White*, *supra* note 1174.
[1179] *Id*; *Osselaer*, at 406.
[1180] *Id*; *Nagy et al*, *supra* note 84, at 548.
[1181] §21. 15 U.S.C.A. § 78u. *See White, supra* note *1174; Osselaer*, *supra* note 747, at 402-03; Enforcement Manual, *supra* note 1126, at §2.3.
[1182] *Osselaer*, *supra* note 1174, at 403; Hilton Foster, *Insider Trading Investigation*, Securities and exchange Commission, 4, *available at:* https://www.sec.gov/about/offices/oia/oia_enforce/foster.pdf.
[1183] *Id*.

to obtain a court order to use wiretapping especially when there is no apparent connection between the trader and an insider.[1184]

Proving that the insider has acted with scienter is a fact-specific issue and there is no general rule that determines the amount or nature of evidence to show when an insider has been subjectively aware of possessing material non-public information when he/she traded a security,[1185] or that the tipper has tipped or transferred material non-public information, and the tippee was in possession of such information.[1186] That said, in a civil proceeding, courts require that scienter is established by direct or circumstantial evidence in which the fact-finder can extract from such evidence a permissible inference of finding knowledge or being reckless in not knowing,[1187] or in a criminal proceeding, to infer willful

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[1184] *Nagy et al*, *supra* note 84, at 548; *Osselaer*, *supra* note 1174, at 405.

[1185] *See LANGEVOORT, supra* note *6, at* §3:13; *WANG & STEINBERG, supra* note *5, at* 188; DANIEL J. FETTERMAN AND MARK P. GOODMAN, DEFENDING CORPORATION AND INDIVIDUALS IN GOVERNMENT INVESTIGATIONS, §14:15, Westlaw (database updated up to Dec. 2017).

[1186] *Id*.

[1187]*See SEC v. Ginsburg*, 362 F.3d 1292 (11th Cir. Cir. 2004). (The SEC brought a civil action against Scoot Ginsburg, who was chairman and CEO of Evergreen Media Corporation, for violating §10(b) and Rules 10b-5 and 14e-3. Id. at 1296. "The case was tried to a jury which found that Ginsburg had violated the insider trading provisions." *Id*. However, the district court granted Ginsburg's renewed motion for judgment as a matter of law and vacated the judgment against him, because it concluded that the evidence was insufficient to permit a reasonable jury to find that he had tipped his brother and father through phone calls about inside information who then traded after receiving the phone calls. *Id*. The SEC appealed. *Id*. The Eleventh Circuit found that: "people generally buy when they believe the price of a stock is going up and sell when they believe it is going down (either absolutely or relative to the expected performance of other stock). The factfinder in an insider trading case need only infer the most likely source of that belief. The temporal proximity of a phone conversation between the trader and one with insider knowledge provides a reasonable basis for inferring that the basis of the trader's belief was the inside information. The larger and more profitable the trades, and the closer in time the trader's exposure to the insider, the stronger the inference that the trader was acting on the basis of inside information." *Id*. at 1299. Ginsburg tried to rebut it by demonstrating evidence that the conversations were frequent and the trades by his brother and father were not exceptional along with the "longer spans of time between the conversations and trades." In addition, Ginsburg also showed some public information about the companies in an attempt to show that that the motive was not because of receiving confidential information. *Id*. at 1301. However, the Eleventh Circuit concluded that: "The district court commented that 'it is plausible that the investments ... were driven not by tips but rather by public knowledge.' It is also plausible that they were driven by insider information. And it was up to the jury to choose between those competing plausible theories of fact." *Id*. "The SEC did not have the burden of putting in evidence that compelled the inference Ginsburg conveyed nonpublic information to Mark. All it was required was put in evidence that reasonably permitted that inference. It did that. The call/trade pattern occurrences coupled with the jury's right to disbelieve the innocent explanations of the calls intent without a reasonable doubt.[1188] For example, circumstantial evidence may include facts of suspicious trades in volume and time, attempts to hide the trades from being noticed, such as the use of multilabel brokers or portfolio accounts, the timing of a trade that follows personal meetings, or a telephone conversation with someone who knows material non-public information.[1189] Professor Donald C. Langevoort observed that: "many courts have wisely taken the position that the timing of the trade (e.g., shortly after a telephone conversation with someone who clearly knew the information and had some

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and trades are enough to support the verdict." *Id*. *See* CORPORATE COUNSEL'S GUIDE TO INSIDER TRADING & REPORTING, § 4:9 Westlaw (2018 ed.).

[1188] *See U.S. v. Cassese,* 428 F.3d. 92 (2nd Cir. 2005). (The Second Circuit examined the issue of whether all of the evidence together was sufficient to support a jury's finding that Cassese willfully violated the Securities laws. Cassese, on behalf of Computer Horizon, entered merger negotiations with another company, Compuware. *Id*. at 95. The deal did not happen. *Id*. The CEO of Compuware informed Cassese that Compuware would not be doing a deal with Computer Horizon but might be interested in the future. He also told him that his company was going to announce a deal with Data Processing Resources Corporation (DPRC), but he did not reveal any details about the terms or structure of the deal. Cassese bought shares on DPRC through two brokerages, and later sold it for profit. *Id*. at 96. After being found guilty by the jury of violating Rule 14e-3, Cassese moved for a judgment of acquittal. *Id*. at 97. He argued that the government failed to prove that he knew the transaction was a tender offer, and that the government's evidence of criminal intent was circumstantial and consistent with his announcement. *Id*. In a renowned motion, the district court concluded that "in criminal persecutions under Section 14(e) and Rule 14e-3… [T]he Government, to prove willfulness, must prove that the defendant believed that the material non-public information he traded upon related, or most likely related to, a tender offer." *Id*. On appeal by the government, the government argued that "it was not required to prove that Cassese believed that he was relating violating a particular law, nor that he was violating a rule that government trading related specifically to a tender offer." *Id*. at 98. The government stated that "all was needed was prove beyond a reasonable doubt that Cassese realized that he was committing a wrongful act. The Government contends that the evidence showed that Cassese believed it was unlawful to trade securities based upon insider information when he purchased DPRC shares, and that this realization was enough to establish a willful violation of Rule 14e–3 even if he was not aware that the trades violated a rule regulating trading in connection with tender offers." *Id*. However, the Second Circuit concluded that "even under the Government's relaxed theory of criminal liability…[I]t did not adduce enough evidence to prove beyond a reasonable doubt that Cassese believed that he was acting unlawfully." Then, the Second Circuit stated that: "Since few events in the life of an individual assume the importance of a criminal conviction, we take the 'beyond a reasonable doubt' requirement with utmost seriousness. Here, we find that the Government's evidence failed to reach that threshold. As discussed above, viewed singly, each of the areas of proof by the Government was characterized by modest evidentiary showings, equivocal or attenuated evidence of guilt or a combination of the three. More importantly, when the evidence is viewed in its totality, the evidence of willfulness is insufficient to dispel reasonable doubt on the part of a reasonable fact finder. Viewed in the most favorable to the prosecution, the evidence, at best, gives "equal or nearly equal circumstantial support to a theory of guilt and a theory of innocence," and thus "a reasonable jury must necessarily entertain a reasonable doubt." *Id*. at 103. *See WANG & STEINBERG, supra* note *5, at* 620 Nt. 30.

[1189] *See WANG & STEINBERG, supra* note *5, at* 188. (The authors reviewed several circumstantial pieces of evidence that have been used to show scienter by courts.) *See* also CORPORATE COUNSEL'S GUIDE TO INSIDER TRADING & REPORTING, *supra* note 1187.

reason to pass it on) suffices to create an inference of insider trading, but only if such a trade was inconsistent with the defendant's prior pattern of trading activity."[1190]

Civil Penalties and Criminal Sanctions against Illegal Corporate Insider Trading Wrongdoers

There are multiple civil penalties and criminal sections that can be imposed upon illegal corporate insider trading violators. This section focuses on potential civil and criminal penalties that are directly relevant to illegal corporate insider trading violations. These possible penalties are discussed below.

SEC's Administrative and Civil Enforcement

The SEC has various options to seek enforcement against charged persons for illegal corporate insider trading activities. These options can be divided into two parts based on the forum that the SEC may choose to enforce the prohibition of illegal corporate insider trading. In general, the SEC can seek civil penalties, injections, and equitable relief including disgorgement, a bar from the industry, or cease and desist orders.[1191]

a. Administrative Enforcement

The SEC can bring an administrative cease and desist order against any person for violating federal laws including illegal corporate insider trading. A cease and desist order is an "order prohibiting a person from continuing a particular course of conduct."[1192] Section 21C of the SEA states that if the SEC "finds, after notice and opportunity for hearing, that any person is violating, has violated, or is about to violate any provision of

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[1190] *LANGEVOORT, supra* note *6, at* §3:13.
[1191] *See WANG & STEINBERG, supra* note *5, at* 639; RALPH GERSTIEN, *PROSECUTION AND DEFENSE OF INSIDER TRADING CASES BROUGH BY GOVERNMENT—CRIMINAL AND CIVIL*, 166 American Jurisprudence Proof of Facts 3d 1, §13, Westlaw (database updated Nov. 2018); Liza Casabona, Editor, 1030 Litigating with the SEC: Choice of Forum, 2005 WL 4919004 (Westlaw); *LANGEVOORT, supra* note *6, at* §8:17.
[1192] Black's Law Dictionary (10th ed. 2014).

this title…the Commission may enter an order requiring such person…to cease and desist from committing or cause such violation and any future violation of the same provision."[1193] By bringing a cease and desist order, the SEC can prohibit any person from serving as an officer or director of an issuer if it is determined that the person has acted in violation of Section 10(b) or rules thereunder and if "the conduct of that person demonstrates unfitness to serve as an officer or director of any such issuer."[1194] In addition, the SEC can impose civil money penalties against illegal corporate insider trading wrongdoers.[1195] In a cease and desist proceeding, Section 21B (c) of the SEA allows the SEC to impose civil money penalties against any person that "is violating or has violated any provision…Or was a cause of the violation."[1196] These civil penalties are divided into three tiers with a maximum civil money penalty of $100, 000 for a natural person and $500,000 for entities other than a natural person.[1197]

b. Civil Enforcement

The SEC has other options to seek before federal courts beyond pursing administrative proceedings. For example, the SEC can request that a federal court issue a restraining order or a freeze request, which is not available in the SEC's administrative proceedings.[1198] In addition, the SEC can seek civil money penalties against illegal corporate insider trading violators and controlling persons, temporary restraining orders,

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[1193] §21C (a). 15 U.S.C.A. § 78u-3. For more discussion about this provision, *see* JACOBS, *supra* note 93, at §12:132.
[1194] §21C (f). 15 U.S.C.A. § 78u-3.
[1195] *See LANGEVOORT, supra* note *6, at* §8:17; *Casabona*, *supra* note 1191.
[1196] §21B (a)(2), 15 U.S.C.A. § 78u-2.
[1197] *Id*. §21B (b). *See Choi & Pritchard*, *supra* note 1122, at 8; *LANGEVOORT, supra* note *6, at* §8:17; JACOBS, *supra* note 93, at §12:133.
[1198] *See Casabona*, *supra* note 1191; *Choi & Pritchard*, *supra* note 1122, at 9; Katherine H. Brown, *SEC Civil Remedies for Insider Trading Actions under Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5*, 57 U. Cin. L. Rev. 679 (1988).

and injunctive and ancillary relief including disgorgement and barring them from the industry. Section 21(d) of the SEA empowers the SEC when "any person is engaged or is about to engage in acts or practice constituting a violation" to seek to prevent such action in the proper federal court and "upon a proper showing a permanent or temporary injunction or restarting."[1199] The SEC can also obtain a temporary restraining order and/or freeze assets by showing evidence inferring that the potential defendant has traded on inside information.[1200] When the SEC seeks permanent injunctive relief, it can also request other equitable remedies.[1201] It may also seek disgorgement of ill-gotten profit made or loss avoided.[1202] In addition, the SEC can ask the court to prohibit any person who violates the

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[1199] §21(d)(1), 15 U.S.C.A. § 78u. Injunction means: "A court order commanding or preventing an action." Injunction, Black's Law Dictionary (10th ed. 2014).

[1200] *Id*. *See* GERSTIEN, *supra* note 1191, at §17. A temporary restraining order is also termed "Preliminary injunction" which means: "A temporary injunction issued before or during trial to prevent an irreparable injury from occurring before the court has chance to decide the case. Injunction, Black's Law Dictionary (10th ed. 2014).

[1201] *See* §21(d)(5), 15 U.S.C.A. § 78u. Equitable remedy is: "a nonmonetary one such as an injunction or specific performance, obtained when available legal remedies, monetary damages, cannot adequately redress the injury." Remedy, Black's Law Dictionary (10th ed. 2014).

[1202] §21(d)(5). Although there is no an express statutory provision that empowers the SEC to seek disgorgement, §21(d)(5) of the SEA implicitly endorsed the SEC to request disgorgement. §21(d)(5) states that: "In any action or proceeding brought or instituted by the Commission under any provision of the securities laws, the Commission may seek, and any Federal court may grant, any equitable relief that may be appropriate or necessary for the benefit of investors." *Id*. Courts have recognized that the SEC has the right to seek disgorgement as a part of an equitable remedy. *Securities and Exchange Commission v. Texas Gulf Sulphur Co.,* 446 F.2d 1301, 13008 (2nd Cir. 1971). "The SEC may seek other than injunctive relief in order to effectuate the purposes of the Act, so long as such relief is remedial relief and is not a penalty assessment." *Id*. *S.E.C. v. Materia,* 745 F.2d 197, 200-01 (2nd Cir.1984) (The Second Circuit asserted that "given the federal courts' broad equitable powers, such noninjunctive relief may take a variety of forms. Disgorgement of illegally obtained profits is by no means a new addition to this catalogue of permissible equitable remedies. Indeed, in *Texas Gulf Sulphur, supra,* this court affirmed a district court order requiring individual defendants to pay over the profits realized from trading on insider information.") *Id*. In general, disgorgement means: "the act of giving up something (such as profits illegally obtained) on demand or by legal compulsion." Black's Law Dictionary (10th ed. 2014). "Disgorgement is a type of restitutionary remedy that seeks to deprive the defendant of any monetary gains obtained through trading on nonpublic material information." *Brown*, *supra* note 724, at 1198. The measure of disgorgement applied by courts is "Disgorgement needs only be a reasonable approximation of profit causally connected to the violation*." SEC v. First City Financial Corp., Ltd., 890 F.2d 1215,1230 (1989).* This measure was adopted by the Distract Court of the District of Columbia. For more discussion about disgorgement, *see LANGEVOORT, supra* note *6, at* §8:11; *WANG & STEINBERG, supra* note *5, at* 652; JACOBS, *supra* note 93, at §20:109.

illegal corporate insider trading prohibition under Section 10(b) and Rule 10b-5 to serve as an officer or director of an issuer "if the person's conduct demonstrates unfitness to serve as an officer or director of any such issuer."[1203]

The most important remedy that the SEC may seek to enforce illegal corporate insider trading prohibition is a civil money penalty. Section 21A of the SEA empowers the SEC to seek civil money penalty before a Federal court against any person who appears to violate the prohibition of illegal corporate insider trading by "purchasing or selling a security…[W]hile in possession of material, nonpublic information…or…[B]y communicating such information."[1204] The SEC can seek a civil money penalty up to three times the profit gained or loss avoided.[1205] In addition, the SEC may request a civil monetary penalty upon controlling persons who control the violator of illegal corporate insider trading prohibition, which must not exceed the greater of $1,000,000 or three times the amount of the profit gained, or loss avoided as a result of the illegal trade. However, if the violation was in the form of communication material non-public information, the controlling person may only be liable to pay the profit gained or loss avoided if the controlling person directed the violator to communicate such information.[1206] The terms "profit gained" and "loss avoided" are defined by the statute as "the difference between the

[1203] §21(d)(2), 15 U.S.C.A. § 78u.

[1204] §21A(a), 15 U.S.C.A. § 78u-1.

[1205] *Id*, *See* GERSTIEN, *supra* note 1191, §20; *Casabona*, *supra* note 1191, at 1033; JACOBS, *supra* note 93, at §20:171; *WANG & STEINBERG, supra* note *5, at* 664; *LANGEVOORT, supra* note *6, at* §8:2.

[1206] However, §21A(b) provides a limitation for a controlling person liability, in which the controlling person may be subject to pay such penalty unless it is established that "(A) such a controlling person knew or recklessly disregarded the fact that such controlled person was likely to engage in the act or acts constituting the violation and failed to take appropriate steps to prevent such act or acts before they occurred; or (B) such controlling person knowingly or reckless failed to establish, maintain, or enforce any policy or procedure required under Section 15(f) of this title or section 204A of the Investment Advisors Act of 1940 and such failure substantially contributed to or permitted the occurrence of the act or acts constituting the violation." *Id*. (b). *See* JACOBS, *supra* note 93, at §20:171.

purchase or sale price of the security and the value of that security as measured by the trading price of the security a reasonable period after public dissemination of the nonpublic information."[1207]

Criminal Enforcement

The most severe punishment that may be imposed upon illegal corporate insider trading wrongdoers who willfully trade on or tip material non-public information is penalties that follow a conviction in criminal enforcement action taken by the DOJ. According to Section 32(a) of the SEA, "any person who willfully violates any provision of the SEA…shall upon conviction be fined not more than $5,000,000, or imprisoned not more than 20 years, or both, except that when such person is a person other than a natural person, a fine not exceeding $25,000,000 may be imposed."[1208] In addition to facing imprisonment and a fine, courts may also impose criminal forfeiture of illegal profits gained because of the violation.[1209]

Private Cause of Action for Contemporaneous Traders

Prior to enacting the ITSFEA of 1988, the courts have had conflicting opinions of whether private investors can sue and seek damages under Section 10(b) and Rule 10b-5

[1207] §21A(e), 15 U.S.C.A. § 78u-1. *See WANG & STEINBERG, supra* note *5, at* 670. (The authors find that the statute refers to a measure of the civil penalty that courts may impose "the facts and circumstances," However, it "provides no guidance as to which facts and circumstances should be considered. A number of courts have applied a three-factor analysis focusing on (1) the egregiousness of the violation; (2) whether the violation was an isolated; and (3) the degree of scienter involved." *Id*. *See* also JACOBS, *supra* note 93, at §20:171; *LANGEVOORT, supra* note *6, at* §8:2.

[1208] §32(a), 15 U.S.C.A. § 78ff. For more discussion about the definition of willfulness, *see supra* note 1146. In corporate insider trading criminal cases, the judicial sentence is subject to the advisory United States Sentencing Guideline Manual. United States Sentencing Commission, Guidelines Manual 2018, Ch. 1 Pt. 1, available at https://www.ussc.gov/sites/default/files/pdf/guidelines-manual/2018/GLMFull.pdf. Illegal corporate insider trading is addressed in the Guidelines at §2B1.4. The base level of an illegal insider trading offense is eight. To this base level is added several levels matching the gain resulting from the offense. Both prison terms and fines are based on the resulting figure. *See WANG & STEINBERG, supra* note *5, at* 631.

[1209] *See LANGEVOORT, supra* note *6, at* §8:13.

against violators of corporate insider trading law.[1210] In particular, they disagreed about the finding of a causal connection between the illegal corporate insider trading violations and the loss claimed by such investors during trading at the time of the violations.[1211] In 1988, Congress enacted Section 5, which became Section 20A of the SEA, an express private cause of action for contemporaneous traders to seek damages against illegal corporate insider trading violators and controlling persons when the violation has co-occurred. This section states that:

> Any person who violates any provision of this title or the rules or regulations thereunder by purchasing or selling a security while in possession of material, nonpublic information shall be liable in an action in any court of competent jurisdiction to any person who, contemporaneously with the purchase or sale of securities that is the subject of such violation, has purchased (where such violation is based on a sale of securities) or sold (where such violation is based on a purchase of securities) securities of the same class.[1212]

[1210] For more discussion about the judicial debate of whether private investors have a stand to *see*k damages against insiders for trading on inside information, *see* Peter J. Henning, *Between Chiarella and Congress: A Guide to the Private Cause of Action for Insider Trading under the Federal Securities Laws*, 39 U. Kan. L. Rev. 1 (1990); HAZEN*, supra* note 2, at §12:169; *LANGEVOORT, supra* note *6, at* §9:1; *WANG & STEINBERG, supra* note *5, at* 508.
[1211] *See Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.,* 495 F.2d 228(2nd Cir. 1974). (The Second Circuit provided justification to allow private investors to seek damages against illegal insider trading violators. It found that, "If underwriter of debenture offering did divulge material inside information concerning corporation's earnings to certain of its customers and if customers sold stock of corporation on national securities exchange without disclosing the information, underwriter and customers could be held liable in private action for damages to buyers who, during period in question, purchased stock of the corporation in the open market without knowledge of the material inside information." *Id*. West Headnotes 7. *Fridrich v. Bradford,* 542 F.2d 307, 318-19(6th Cir. 1976). (The Sixth Circuit stated that: "Investors must be prepared to accept the risk of trading in an open market without complete or always accurate information. Defendants' trading did not alter plaintiffs' expectations when they sold their stock, and in no way influenced plaintiffs' trading decision. We hold, therefore, the defendants' act of trading with third persons was not causally connected with any claimed loss by plaintiffs who traded on the impersonal market and who were otherwise unaffected by the wrongful acts of the insider.") *Id. Moss v. Morgan Stanley Inc., 719 F.2d* 5, 16 *(1983)*: (In the wake of *Chairella,* the Second Circuit rejected to grant a private cause of action and stated that "while we agree that the general purpose of the securities laws is to protect investors, the creation of a new species of 'fraud' under section 10(b) would 'depart radically from the established doctrine that duty arises from a specific relationship between two parties ... and should not be undertaken absent some explicit evidence of congressional intent.") *Id.*
[1212] §20A(a), 15 U.S.C.A. § 78t-1. This section also, under subsection (3), states that controlling persons may be liable under the same standard of liability provided under Section 20(a) of the SEA. §20(a) of the SEA states "Every person who, directly or indirectly, controls any person liable under any provision of this title or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable…unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action." 15 U.S.C.A. § 78t. §20A(c) provides private cause of action against tippers, which states

Section 20A (a) limits the cause of action to contemporaneous traders of the same class of security who are on the opposite side of the transaction in question.[1213] However, it does not define "contemporaneous traders" and left this issue to be developed by courts.[1214] When a court grants a judgment in favor of contemporaneous traders, they are entailed to receive compensation for damages that must not exceed the profit gained or loss avoided by the violator and shall be offset by any disgorgement paid by the violator.[1215]

Statutes of Limitation

The SEC civil enforcement to impose civil penalties upon illegal corporate insider trading violators is limited to up to five years after the date of the purchase or sale on the basis of inside information.[1216] However, the SEC civil action for injunctive relief under Section 21(d)(1) of the SEA has no statute of limitation.[1217] For criminal enforcement brought under Article 32(a) of the SEA, the statute of limitation is six years from the time

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that: "Any person who violates any provision of this title or the rules or regulations thereunder by communicating material, nonpublic information shall be jointly and severally liable under subsection (a) with, and to the same extent as, any person or persons liable under subsection (a) to whom the communication was directed." *Id*.

[1213] *See Henning*, *supra* note 1210, at 32.

[1214] *See LANGEVOORT, supra* note *6, at* §9:3. (Professor Donald Langevoort has observed that, to date, "the courts have not given concrete meaning to the term either. One tendency has been to construe contemporaneousness narrowly, with suggestions that standing might well be limited to those who can show—for widely traded securities, at least—that they traded within a day or so of the insider. Indeed, many courts now insist on same day trading.") *Id*. *WANG & STEINBERG, supra* note *5, at* 521. (The authors reviewed the judicial development of the definition of "contemporaneous traders," and concluded that the class of contemporaneous traders opens when the insider trades. However, the time of the class of contemporaneous ends is not agreed by courts. Many courts have endorsed that same-day trading is contemporaneous.) *Id*.

[1215] §20A(b), 15 U.S.C.A. § 78t-1. "The total amount of damages imposed under subsection (a) shall not exceed the profit gained or loss avoided in the transaction or transactions that are the subject of the violation….The total amount of damages imposed against any person under subsection (a) shall be diminished by the amounts, if any, that such person may be required to disgorge, pursuant to a court order obtained at the instance of the Commission, in a proceeding brought under section 21(d) of this title relating to the same transaction or transactions…" *Id*. *See*

[1216] SEA, §21A(d)(5), 15 U.S.C.A. § 78u-1. ("No action may be brought under this section more than 5 years after the date of the purchase or sale.") *Id*.

[1217] *See WANG & STEINBERG, supra* note *5, at* 649.

of perpetrating the crime.[1218] In addition, a private cause of action ends after the elapse of five years from "the date of the last transaction that is the subject of the violation."[1219]

Summary

Part 4 discusses governmental enforcement of the prohibition of illegal corporate insider trading and potential civil and criminal liability that may ensue from a violation of the prohibition. This part reveals that there are two general elements of an illegal corporate insider trading violation including the prohibited conduct which is the purchase or sale of a security on the basis of material non-public information in a breach of fiduciary-like duty of trust and confidence, and the state of mind of the violator which must constitute of intentional and deliberate intent to violate the prohibition in criminal proceedings or at least constitute a reckless standard in civil proceedings. This part reveals that the standard of proof in civil lawsuits is more flexible and lower than the standard in criminal proceedings, which means that facing civil liability is more likely than criminal liability.

This part also indicates that the major sanctions and penalties are civil monetary penalties up to three times the amount of ill-gotten gain or the loss avoided in civil proceedings and fines up to 5 million dollars for natural persons and imprisonment of no more than 20 years in criminal prosecution.

[1218] 18 U.S.C.A. § 3301 ("No person shall be prosecuted, tried, or punished for a securities fraud offense, unless the indictment is found or the information is instituted within 6 years after the commission of the offense.") *Id*. at (b).
[1219] §20A(b)(4), 15 U.S.C.A. § 78t-1.

Part 5. Summary of Chapter 2

The objective of Chapter 2 is to determine the U.S. corporate insider trading regulations by answering three general questions: (1) What differentiates corporate insiders from other market participants that prompts securities laws to regulate their securities trading activities? (2) When can corporate insiders legally trade in accordance with federal securities laws? and (3) When are they prohibited from trading?

This chapter reveals that corporate insiders are subject to a fiduciary duty under corporate state law, which makes them vulnerable to liability whenever they misuse confidential information for their personal advantage. This includes trading in the corporation's stock on the basis of material non-public information. Corporate insiders including directors, officers, and large shareholders, are a special group among the main players in securities markets that Congress has sought to regulate within the SEA. The basis of the justification has been that to maintain investors' confidence in securities markets, corporate insiders, as fiduciaries who are entrusted to manage and control public corporations, shall not be permitted to misappropriate confidential information for their personal benefit.[1220] Corporate insiders are regulated under Section 16 of the SEA where they are subject to public disclosure requirements about their securities ownership and trading transactions, and prevented from making short-swing profit that results from speculative trading transactions within a six-month period. They are also prohibited from making short-sale transactions.[1221]

Although Section 16 of the SEA seeks to prevent insiders from misusing their trust position by abusing confidential information for trading purposes, it does not generally

[1220] *See supra* note 265 and accompanying text.
[1221] *See supra* note 259-62 and accompanying text.

prohibit corporate insiders from trading on material non-public information in their corporations' security. However, the prohibition of trading on material non-public information was first imposed and developed by the SEC, and then by federal courts. This prohibition has developed to cover a broader scope of persons and goes beyond corporate insiders and others who have a fiduciary-like relationship with the corporation or its shareholders. It includes any person who trades on material non-public information in breach of his/her direct or derivative fiduciary-like duty of trust and confidence either owed to the other party in transaction or to the source of the information.[1222]

While the boundaries of legal and illegal corporate insider trading are not completely clear,[1223] one could deduce that corporate insiders can legally trade in two situations: (1) the trade is based on a personal assessment and sophisticated evaluation at a time when the insider is not aware of material non-public information; and (2) when the trading transaction is made pursuant to a written trading plan even if the insider is aware of material non-public information at the time of the execution of the trade given that the trading transaction is executed in good faith.

[1222] Although this is the dominate determination in U.S. law, few cases and new trends make it unlawful to trade on inside information wrongfully obtained through deception disregarding of the existence of a breach of fiduciary duty. *See supra* notes 660, 683 and accompanying text.

[1223] *See* HAZEN, *supra* note 2, at §12:160.

Chapter 3. Saudi Arabian Corporate Insider Trading Regulations

Introduction

Chapter 3 describes the Saudi Arabian corporate insider trading regulations by dividing the chapter into five parts. The first part determines the legal status of companies' insiders in Saudi Arabia and provides a general understanding of insiders' duty. The second part goes to examines the regulations governing legal corporate insider trading. The third part intensively examines the regulations governing illegal corporate insider trading. The fourth part discusses governmental enforcement of the prohibition of illegal corporate insider trading, and the last part provides a summary of this chapter.

Part 1. Legal Status of Corporate Insiders

Introduction

Directors of JSCs listed in the Exchange possess the default statutory power and authority to manage and control the JSC's business and property. According to the CL of 2015, a JSC "shall be managed by a board of directors whose number…is not less than 3 and not more than 11."[1224] Article (75) of this law also states that "the board of directors shall have full powers to manage the company in a manner that serves its purposes, except for powers entrusted to the general assembly…"[1225] The CL of 2015 gives the board of directors the power to control the internal as well external business realm of a JSC.[1226] For instance, the board of directors holds the power to determine the goals and objectives of the company, to monitor the business operations, and to assess the achievements of the

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1224 CL of 2015, *supra* note 179, art. 68(1).
1225 *Id*. art. 75.
1226 *Id*.

determined objectives.[1227] In addition, it has the authority to represent the company in front of third parties.[1228] It has the right "to enter into loan agreement" and to "relieve the company's debtors from liability."[1229]

Due to these vast default powers in the hands of JSC directors, potential abuse of power and deviation from the goals and interests of the JSC is a reasonable concern for public investors.[1230] Therefore, the question is whether JSC directors and managers owe any legal duty that can restrain them from abuse of their power including misusing confidential information for trading purposes. As discussed later in this chapter, Saudi securities regulators have imposed restrictions and legal obligations upon JSC directors, senior executives, and to some extent substantial shareholders related to their securities ownership and trading activities.[1231] However, this part attempts to answer this question from a conceptual and theoretical perspective of why JSC insiders in Saudi Arabia are a unique class of traders.[1232]

This part discusses the Saudi Arabian legal perspective of directors' and managers' legal status. It starts with a discussion of the legal status of JSC directors and executives in accordance with Islamic law. Next, it examines the related articles under CL of 2015 and CGR, and then assesses insiders' status.

[1227] *Id*. art, 75. *See* also Khalid Al-Habshan, *The Current Rights of Minority Shareholders in Saudi Arabia*, International Law Research; Vol. 6, No. 1, 195 (2017), *available at*: https://bit.ly/2DZigVC; Mohamed Soliman, *Ownership Structure, Board Composition, and Dividend Policies Evidence from Saudi Arabia*, 4 (2013), *available at*: https://bit.ly/2MTfBzr.
[1228] *Id*.
[1229] *Id*.
[1230] *See Al-Jaber*, *supra* note 179, at 286.
[1231] *See* discussion *infra* Part 2 of this Chapter. PP. 225.
[1232] *Id*. *See* also Mahayni, *supra* note 160, at 147.

Do Corporate Insiders Have a Special Status?

Some commentators have argued that the concept of fiduciary duty is not addressed by the CL of 2015 or CGR since neither set of laws contains articles expressly addressing the concepts of "fiduciary duty" or "the principal-agent relationship."[1233] They have suggested that this approach follows the most contemporary companies laws in the Middle East, where directors' and managers' fiduciary duty is a "nascent legal concept."[1234] That said, some commentators have observed that the notion of regulating corporate governance including insiders' fiduciary duty by statutory articles is a fairly new concept for Saudi Arabian regulatory institutions and for directors and investors.[1235] In fact, the regularization of corporate governance in Saudi Arabia is still in the process and review stage. In 2017, the CMA introduced the CGR based on the new Saudi CL of 2015, which includes Articles governing self-dealing and company opportunities. These articles were amended on April 17, 2018.[1236] Thus, they argue that the regulations related to corporate governance including the fiduciary duty of JSC insiders are still novel. In addition, companies have

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[1233] *See Al-Habshan*, at *supra* note 1227, at 196.

[1234] *See* Berg, Alexander S.; Di Benedetta, Pasquale, the World Bank, Report on the Observance of Standards and Codes (ROSC), *Cooperate Governance Country Assessment-Kingdom of Saudi Arabia*, 31 (2009), http://documents.worldbank.org/curated/en/838731468106752813/Kingdom-of-Saudi-Arabia-Report-on-the-Observance-of-Standards-and-Codes-ROSC-corporate-governance-country-assessment; *Al-Habshan, supra* note *1227*, at 196 citing Lu'ayy Al-Rimawi, *Emerging markets of the Middle East: A critique of selected issues in Arab securities regulation,* Journal of Financial Regulation and Compliance 7(2), 160 (1999); MESHAL FARAJ, *TOWARD NEW CORPORATE GOVERNANCE STANDARDS IN THE KINGDOM OF SAUDI ARABIA: LESSONS FROM DELAWARE*, 53 (2014).

[1235] Ayman Mohamed Zerban ed al, *Corporate Governance of Directors Responsibility in Appointing Senior Mangers: A Case in Saudi Arabia*, International Journal of business and Management; Vol. 13, No.1, at 186 (2018).

[1236] Um Al-Qura (the Official Gazette), Royal Decree No. 79 (dated 25/7/1439H corresponding to 4/11/2018), visited on Aug 22, 2018 (April 17, 2018) *available at* uqn.gov.sa. The CGR also was amended in March 28, 2018 and some of the amendments went into effect on January 1, 2019. *See* The Capital Market Authority, The Capital Market Authority Approves the Amendments of the Corporate Governance Regulations, (2018), https://cma.org.sa/en/MediaCenter/PR/Pages/CGRAmendments.aspx.

little experience and awareness of the concept of fiduciary position in JSCs, and the application of the law is still being determined.[1237]

However, Saudi Arabia's approach of not specifically codifying the concepts of fiduciary duty and the principal-agent relationship does not mean that these concepts are novel or unknown to Saudi Arabian law and to judges. Islamic law, which is the "ultimate source of reference" in Saudi Arabia, [1238] contains legal rules, as is illustrated below, that govern the JSC's insiders' fiduciary position and the liability of their breach of duty. Thus, in the absence of regulatory articles, judges are directed to step in and fill the legal gaps based on legal rules of Islamic law.[1239] Furthermore, by promulgating the CGR that governs the corporate governance of listed JSCs, the CMA has expressly stated under several articles that JSC directors are subject to legal duties that require them to comply with the principles of loyalty, honesty, and care.

Corporate Insiders Legal Status under Islamic Law

Overview

The idea of creating a company as an artificial entity that has a separate legal status from its shareholders was an unknown concept in classical Islamic jurisprudence.[1240] Historically, classical Islamic jurists recognized several forms of capital contractual

[1237] *See* Zerban et al, *supra* note 1235.
[1238] Basic Law of Governance, *supra* note 160, art. 7 (This Article states that "Government in the Kingdom of Saudi Arabia derives its authority from the book of god and the Sunnah of the prophet (PBUH), which are the ultimate source of reference for this Law and other laws of the state.") *Id*.
[1239] *See id*. art. 48. (Article 48 states that "the courts shall apply rules of Islamic Shari'ah in cases that are brought before them, according to the Holy Qur'an and the Sunna, and according to laws which are decreed by the ruler in agreement with the Holy Qur'an and the Sunna.") *Id*. FARAJ, *supra* note 1234, 45 (2014); *See Al-Jaber*, *supra* note 179, at 7.
[1240] MUHAMMAD UMER CHAPARA, TOWARDS A JUST MONETARY SYSTEM, THE ISLAMIC FOUNDATION, 254 (1985); Abdul-Aziz Khayyat, *al-shirkat fi al- shari'a al-Islamiyyah wa all-Qanun al-Wad'I* [The Companies in Islamic Shari'a and Statuary Laws], 213 (4th ed. 1994). (Ar).

partnerships "*sharikat al-amwal*";[1241] however, these forms did not maintain separate legal entity status from the partners.[1242] When the JSC form was brought to Islamic countries by statutory legislation, Islamic jurists sought to examine the characteristics of this company according to Islamic law.[1243] Islamic jurists approved the JSC form based on *qiyas* (analogy) to already established contractual partnerships of *sharikat al-enan (limited partnership)* and *sharikat al-mudaraba (silent partnership)*.[1244] They also ratified this form based on the general legal maxim of *ibaha,* which assumes admissibility and validity of new contracts or transactions by default, unless there is a specific text in *shari'a* that precisely states otherwise.[1245] They determined that recognition of the JSC form is supported by the source of al-*maslahah al-mursalah (public interest)* where the allocation

[1241] The classical forms of sharikat al-amwal (capital contractual partnerships) in Islamic law are two forms of partnerships. (1) *Sharikat al-mufawadah* (unlimited partnership): This partnership requires full equality of the partners in terms of the contributed capital, the right to control, and the profit and liability. WAHBAH AL-ZUHAYLI, FINANCIAL TRANSACTIONS IN ISLAMIC JURISPRUDENCE, 453 (2001); MAHMOUD A. EL-GAMAL, ISLAMIC FINANCE LAW, ECONOMICS AND PRACTICE, 117 (2006); (2) *sharikat al-inan* (limited partnership): "A partnership between two or more parties whereby each partner contributes a specific amount of money in a manner that gives each one a right to deal in the assets of the partnership, on condition that the profit is distributed according to the partnership agreement and the losses are borne in accordance with the contribution of each partner to the capital." Accounting and Auditing Organization for Islamic Financial Institutions [AAOIFI], *Shari'ah Standards*, Manama, 327 (2015), http://aaoifi.com/shariaa-standards/?lang=en; EL-GAMAL, at 117. In addition to these forms of partnerships, Islamic jurists recognized a special form of partnership which involves a contribution of capital by one partner and labor by another, termed *sharikat al-mudaraba* (silent partnership) "An agreement between two or more persons whereby one or more of them provide finance [*sahib al-mal*], while the others provide entrepreneurship and management [*mudarab*] to carry on any business venture whether trade, industry or service, with the objective of earning profits. The profit is shared by them in an agreed proportion. The loss is borne only by the financiers [silent partners] in proportion to their share in total capital." CHAPARA, *supra* note 1240, at 261. The *sahib ul-mal* (financier or silent partner) is a silent partner, which means that he/she has a claim on the profits without any say in the management of the firm." Habib Ahmed, *Islamic Law, Investors' Rights and Corporate Finance*, 12 J. Corp. L. Stud. 367, 381 (2012); EL-GAMAL, at 120; AL-ZUHAYLI, *supra* note 1241, at 485.

[1242] *See* Gohar Bilal, *Business organizations under Islamic Law A brief Overview*, Center for Middle Eastern Studies, Harvard University, 83, 86 (1999), https://bit.ly/2F0oiV1.

[1243] *Ahmed*, *supra* note 1241, at 385; AL-ZUHAYLI, *supra* note 1241, at 526.

[1244] *See supra* note 1241; CHAPARA, *supra* note 1240, at 255; Ahmad N. Azrae et al, *Separate Legal Entity Under Syariah Law and Its Application on Islamic Banking In Malaysia: A note*, International Journal of Banking and Finance: Vol. 6: Iss. 2, article 8, 7 (2009). *See supra* note 1241.

[1245] *Ahmed*, *supra* note 1241, at 386; Muhammad Al-Uthaymin, *Al-Sharh Al-Mumti' Ala Zad Al-Mustaqni',* [Islamic Jurisprudence Book] 9/400 (2008).

of capital and labor into large business organizations that have separate legal entities from its members is an economic need for modren societies.[1246] Some Islamic jurists have concluded that classical Islamic jurisprudence's recognition of specific forms of partnerships was not inclusive, but new emerged forms of partnerships or companies can be recognized on the basis of the default rule of the assumption of admissibility, not the prohibition, regarding commercial status and transactions.[1247]

Although classical Islamic jurisprudence did not recognize the notion of a separate legal entity in capital contractual partnerships, this concept is not foreign to Islamic law. Islamic law applies the concept of giving legal status to a non-human entity in other legal relationships such as a *waqf* (trusts).[1248] When a *waqf* is established, the property of the *waqf* is recognized by Islamic law as a separate legal entity.[1249] Moreover, classical Islamic jurists have recognized the concept of the separation of control and ownership in *sharikat al-mudaraba*, which is one of the major characteristics of JSCs.[1250] Islamic jurists stated

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[1246] CHAPARA, *supra* note 1240, at 255.
[1247] AL-ZUHAYLI, *supra* note 1241, at 525; Al-Uthaymin*, supra* note 1245, at 9/400; Khayyat, *supra* note 1240, at 1/219.
[1248] *See* Khayyat, *supra* note 1240, at 1/217; Azae et al, *supra* note 32, at 146. A *waqf* is "a legal and religious institution wherein a person dedicate some of his properties for a religious or a charitable purpose." Mufti Muhammad Usmani, *An Introduction to Islamic Finance*, 154 (1998). In a *waqf*, Islamic jurists have realized that the ownership of the asset of the *waqf* is not included in the ownership of the beneficiaries or the trustee. Therefore, Islamic law permits the trustee to borrow and lease the property of a *waqf* and conduct other transactions for the benefit of the *waqf*. The trustee, however, is not personally liable for the debt of the *waqf* and is not personally subject of lawsuits for acts he conducts while acting as a trustee. *See Id*.
[1249] *See id*.
[1250] Islamic jurists stated that the *sahib al-mal* (silent partner) has no right of control in *sharikat al- mudaraba*, whereas the *mudarab* (entrepreneur) has the exclusive right to control and manage the business of *sharikat al-mudaraba*. *Al-Mawsueat Al-Faqh'iat Al-Kuwaitia* [Encyclopedia of Islamic Jurisprudence], Kuwait-Ministry of Awqaf & Islamic Affairs, 38/50 (1st ed. 1998); Khayyat, *supra* note 1240, at 286. Moreover, Islamic jurists stated that in regard to *sharikat al-inan* (limited partnership), the partners can agree that one partner who contributes to the capital retains an exclusive right to control the business of *sharikat al-inan* and the others only contribute capital with no right to manage the business. AL-ZUHAYLI, *supra* note 1241, at 452; EL-GAMAL, at *supra* note 1241, at 118; AAOIFI, *supra* note 1241, at 330. Therefore, the managing partner in *sharikat al-inan* also holds the position of *mudarab* (entrepreneur). Al-Uthaymin*, supra* note 1245, at 9/403; CHAPARA, *supra* note 1240, at 255; AAOIFI, *id*.

that the contract of *shirkat al-modarabah* (silent partnership) underlies the separation of the right of control from the right of ownership. Whereas the *sahib al-mal* (silent partner) owns the property of the silent partnership, and the *modarab* (entrepreneur or manager partner) owns the right to control and use the property for the benefit of the silent partnership.[1251]

<u>Corporate Insiders Owe a Fiduciary Duty and Act Based on Agency Authorization</u>

Islamic jurists treat the JSC form as a combination of *sharikat al-Inan* (limited partnership)[1252] and *al-modaraba* (silent partnership)[1253] but with some recognition of the differences between the statutory JSC form addressed in regulations and the Islamic jurisprudential partnership forms.[1254] They also treat the legal status of directors as *modarabain* (manager partners*)* in *Sharikat al Modaraba,* and senior executives as private employees and agents.[1255]

Islamic jurists define the legal status of those who manage the partnership or company according to two main concepts: agency and trust or fiduciary.[1256] Islamic jurists

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[1251] *Id*; Encyclopedia of Islamic Jurisprudence, *supra* note 1250, at 38/65.

[1252] *sharikat al-inan* (Capital limited partnership) can be defined as "a partnership between two or more parties whereby each partner contributes a specific amount of money in a manner that gives each one a right to deal in the assets of the partnership, on condition that the profit is distributed according to the partnership agreement and the losses are borne in accordance with the contribution of each partner to the capital." AAOIFI, *supra* note 1241, at 327; EL-GAMAL, at *supra* note 1241, at 118.

[1253] *sharikat al-mudaraba* (silent partnership) is a special form of partnership that involves contribution of capital by one partner and labor by another. "An agreement between two or more persons whereby one or more of them provide finance [*sahib al-mal*], while the others provide entrepreneurship and management [*mudarab*] to carry on any business venture whether trade, industry or service, with the objective of earning profits. The profit is shared by them in an agreed proportion. The loss is borne only by the financiers [silent partners] in proportion to their share in total capital." CHAPARA, *supra* note 1240, at 261. The *sahib ul-mal* (financier or silent partner) has a claim on the profits without any say in the management of the firm. *Ahmed*, *supra* note 1241, at 381; EL-GAMAL, at *supra* note 1241, at 120*;* AL-ZUHAYLI, *supra* note 1241, at 485.

[1254] CHAPARA, *supra* note 1240, at 255; AAOIFI, *supra* note 1241, at 359; Al-ZUHAYLI, at 529.

[1255] AL-ZUHAYLI, at 529; Khayyat, *supra* note 1240, at 1/249. For convenience, the term JSCs' directors and managers is used instead of using the classical terms.

[1256] AAOIFI, *supra* note 1241, at 355.

have concluded that these concepts of agency authority and fiduciary possession also apply to modern partnerships and companies including JSCs. Islamic jurists have ruled that JSC directors and managers are acting in agency power and are treated as fiduciaries in regard to their possession of the company's capital and assets.[1257]

a. Agency Authorization

Islamic law has ruled that the contract of the capital partnership (*sharikat al-inan*) underlies *wakalah* (agency authorization).[1258] Each partner acts on behalf of himself, in regard to his own part of the partnership's capital and assets, and as an agent for the other partners.[1259] If one partner has an exclusive right to manage the partnership, that partner will have agency authorization on behalf of all partners as the same as the *modarab* (manager partner) in *sharikat al-modaraba*.[1260] Therefore, the agency authorization is the base that justifies the directors and managers' right to act and manage JSC forms[1261]

b. Duty of Trust or Fiduciary (al-*amana*)

In addition to the agency authorization to act and manage, Islamic jurists have ruled that the legal status of directors regarding the control and possession of the capital and assets of the JSC is al-*amana* (trust or fiduciary) and a director is called *al-ameen* (trustee or fiduciary).[1262]

[1257] CHAPARA, *supra* note 1240, at 255; AAOIFI, *supra* note 1241, at 359; AL-ZUHAYLI, *supra* note 1241, at 529.

[1258] AL-ZUHAYLI, at 457. *Wakalah* means: "A contract, which gives the power to a person to nominate another person to act on his behalf as long as he is alive based on the agreed terms and conditions." Islamic Capital Market Fact Finding Report, *Report of the Islamic Capital Market Task Force of the International Organization of Securities Commission*, at annex 2, 5. (2004), https://www.iosco.org/library/pubdocs/pdf/IOSCOPD170.pdf.

[1259] *AL-ZUHAYLI*, at 467; Encyclopedia of Islamic Jurisprudence, *supra* note 1250, at 26/43 (1st ed. 1992).

[1260] *See* also note 36.

[1261] AAOIFI, *supra* note 1241, at 355.

[1262] AL-ZUHAYLI, at 474; CHAPARA, *supra* note 1240, at 255.

Islamic law imposes the legal status of a fiduciary or trustee in connection with several contractual and non-contractual relationships, such as a *waqf*, *wakalah*, *partnership*, and *wilayat* (guardianship).[1263] *Al-ameen* (trustee or fiduciary) can be defined as any person who is in possession of another's property based on the authorization from its owner or by law.[1264] For instance, a guardian of an orphan is a *ameen* because he/she is authorized by law to take possession of the orphan's property. *Al-mutawalli* (the trustee) of a *waqf* is a *ameen* because of the possession of the property of a *waqf* by authorization of the *al-waqif* (the settlor). An agent is a *ameen* because he/she is in possession of the property of the principal by authorization.[1265] Therefore, a director is also a *ameen* because he/she is in possession of the JSC's property by authorization from the shareholders.[1266] A private employee has the same legal fiduciary status because his/her possession of the property of the employer is by the employer's authorization.[1267]

The general rule in Islamic law is that directors, as agents, are entrusted with managing the business operations of the company and using its resources and properties for the benefit of the company within the scope of its business and in accordance with the powers under which they are authorized to act.[1268] Therefore, in the event of loss or damage to the company, the basic rule is that there is no liability upon directors because of that loss or damage without showing *taqsir* (negligence) or *ta'addi* (transgression) acts.[1269] Since

[1263] Encyclopedia of Islamic Jurisprudence, *supra* note 1250, at 6/236 (2nd ed. 1986).
[1264] Al-Uthaymin*, supra* note 1245, at 9/390.
[1265] *Id*. *See also*, Walid Hegazy, *Islamic Liability (Daman) as Practiced by Islamic Financial Institutions*, 25 Wis. Int'l L.J. 797, 98 (2008).
[1266] AL-ZUHAYLI, *supra* note 1241, at 474.
[1267] *Id*, at 421.
[1268] Khayyat, *supra* note 1240, at 1/269; AL-ZUHAYLI, at 501.
[1269] *Id*; Al-Uthaymin*, supra* note 1245, at 9/392; Zainudin Jaffar, *T*he concept and Application of Daman In Islamic Commercial Law, The University of Edinburgh, 141 (1994), https://www.era.lib.ed.ac.uk/handle/1842/17552.

they are the fiduciary, they are believed based on their personal denial of committing a transgression or negligence related to the loss or damage.[1270] However, if the evidence demonstrates that their claim or presentation is untrue, they would lose credibility and may be held liable.[1271]

According to Islamic law, negligence means inaction or refraining from acting where there is a duty to act. Transgression means any act performed in violation of a duty not to act.[1272] Islamic jurists have stated that the standard of what is negligence and transgression is determined based on the conditions laid out in the contract of the company or by custom.[1273] For example, if directors engage in a transaction that is beyond their general authority, that is a transgression act; therefore, they would bear the risk of their actions and may be held liable. If they were lazy in managing the business operations of the company in accordance with customary business practices, they may be deemed negligent and be subject to liability in the event of loss.[1274]

<u>Fiduciary Principles of Corporate Insiders</u>

Islamic jurists state that directors of JSCs are under a duty to act and "exercise maximum possible care and skill in the discharge of their responsibility in the same way as a *mudarib* is expected to do in his capacity as a trustee."[1275] In addition, they must manage the business of the company in a manner that is in the best interest of the

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[1270] Encyclopedia of Islamic Jurisprudence, *supra* note 1250 (1st ed. 1992), at 26/58; AL-ZUHAYLI, *supra* note 1241, at 516.
[1271] *Id*; Al-Uthaymin*, supra* note 1245, at 9/392.
[1272]Ibn Qudamah Al-Maqdisi, *Al-Mughni* [Islamic Jurisprudence Book] (Ar), 7/162 (3rd ed. 1997); Encyclopedia of Islamic Jurisprudence, *supra* note 1250, 13/151 (2nd 1988).
[1273] Al-Uthaymin*, supra* note 1245, at 9/391; Dubayan Muhammad Al-Dubayan, Al-Mu'amalat Al-Maliah Asalah Wa Muaessara [Financial Transactions-Classic and Contemporary] 14/165 (2000) (Ar).
[1274] *See*, AL-ZUHAYLI, *supra* note 1241, at 504.
[1275] CHAPARA, *supra* note 1240, at 255. *See* Khayyat, *supra* note 1240, at 1/280.

company.[1276] They must also refrain from committing any kind of deceptive or unethical acts that involve favoritism, or any other unlawful acts that may harm the company or violate the law.[1277]

Islamic jurists have linked most of the acting powers of directors and derivatively managers to the business' customary practices or the custom of merchants.[1278] Consequently, Islamic jurists have developed four objective categories governing the principal-agent relationship.[1279] The first category includes acts that directors can perform without the need for consent, which include all acts needed to pursue the purpose of the business, such as the purchase or sale of goods; hire employees; and perform other actions that would result in benefiting the company pursuant to its purpose.[1280] The second objective category includes acts that only can be performed by general authorization. This general authorization gives directors the right to undertake all the acts that are normally known to be under the business' customarily practices benefitting the company, such as forming another company or entering into investment transactions.[1281]

The third category covers acts that directors cannot conduct without specific consent, even though general authority was given.[1282] These acts include all conduct that involves favoritism and conflict of interest, such as self-dealing. Otherwise, directors would be subject to liability in front of the company and the shareholders.[1283] This category

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[1276] AAOIFI, *supra* note 1241, at 355.
[1277] Khayyat, *supra* note 1240, at 1/278.
[1278] Khayyat, at 1/248; AL-ZUHAYLI, at 507.
[1279] *See* AL-ZUHAYLI, *id*; Encyclopedia of Islamic Jurisprudence, *supra* note 1250, at 38/55.
[1280] *Id*; Al-Dubayan, *supra* note 1273, at 477.
[1281] AL-ZUHAYLI, *supra* note 1241, at 507-8; Encyclopedia of Islamic Jurisprudence, *supra* note 1250, at 38/61; Al-Dubayan, *supra* note 1273, at 483.
[1282] *Id*.
[1283] Khayyat, supra note 1240, at 1/270. *See* Al-Uthaymin, *supra* note 1245, at 9/423.

also includes acts that are not normally within the business' customarily practice or regular management.[1284] In addition, it includes any action that would result in financial harm or transactions that exceed the available capital of the company.[1285] The fourth category includes acts that directors cannot engage in including acts that are in violation of the law, such as purchasing unlawful goods, even though they are given specific consent to do so.[1286]

The foregoing objective categories show that Islamic law has treated the fiduciary principles of JSC directors under two general considerations: The directors' need for independence in managing and controlling the business and property of the company, and the notion that the relationship between directors and shareholders is based on trust. Therefore, directors are not allowed to go beyond what they are entrusted to do which is managing the company and pursuing its purpose. Directors are not allowed to breach this trust, and they must obtain consent for acts that exceed their basic agency authorization.

Regulatory Articles Addressing Corporate Insiders' Fiduciary Principles

Although the CL of 2015 does not state specifically that directors are subject to a fiduciary duty, the fiduciary duty principles are expressly addressed by the CGR. Article (29) of the CGR states that "each member of the Board shall comply with the principles of truthfulness, honesty, loyalty, and care of the interests of the company and its

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[1284] Encyclopedia of Islamic Jurisprudence, *supra* note 1250, at 38/58; AL-ZUHAYLI, *supra* note 1241, at 507-8.
[1285] AL-ZUHAYLI, *supra* note 1241, at 508; *Jurisprudence Encyclopedia*, *supra* note 5, Dar Al- Safwa, at 38/61; Al-Dubayan, *supra* note 1273, at 463.
[1286] Encyclopedia of Islamic Jurisprudence, *supra* note 1250, at 38/62. Khayyat, *supra* note 1240, at 1/265. *See* Jaffar, *supra* note 1269, 142.

shareholders."[1287] In addition, the CL of 2015 and CGR have addressed detailed articles regarding specific duties of directors that relate to directors' fiduciary or trustee position.

The imposition of these duties is consistent with the concept of directors' fiduciary position and agency capacity under Islamic law,[1288] as is true for most jurisdictions worldwide.[1289] However, the CL of 2015 fails to expressly impose the same duties upon managers and other employees of JSCs. According to legal commentators, the legal status of managers is their agency acting on behalf of the board of directors. This means that the board of directors has the default right to manage the company and the senior executives are merely acting as agents under the board's direction and supervision.[1290] In addition, the CL of 2015 and CGR do not impose the same duties of directors on substantial shareholders.[1291] However, the CGR partially fills this gap.

The CL of 2015 governs the directors' duty of loyalty by addressing specific duties that are characterized as recurring situations involving the duty of loyalty.[1292] The CL of 2015 imposes a duty to refrain from self-dealing, not to compete with the company's business opportunity, and a duty to disclose any conflict of interest involving self-dealing[1293] or the company's opportunity.[1294] It also imposes a duty of maintaining confidentiality.[1295]

[1287] CGR, *supra* note 159, art. 29.
[1288] FARAJ, *supra* note 1234, at 40.
[1289] *See Al-Habshan*, at *supra* note 1227, at 196; Abdullah AlKahtani, The Influence of Corporate Governance on Protecting Minority Shareholders' rights in the Saudi Stock Market: A Comparative Study, 196 (2015), https://westminsterresearch.westminster.ac.uk/download/3c09765d0428e922951f48b4521647698a00353a1f74da4d16f7c28c46f4459d/2267612/Alkahtani_Abdullah_thesis.pdf.
[1290] *Al-Jaber*, at *supra* note 179, at 328.
[1291] FARAJ, *supra* note 1234, at 76. For more discussion about the protection of minority shareholders in Saudi Arabia, *see* AlKahtani, *supra* note 1289, at 90.
[1292] *See* Robert Charles Clark, *Corporate Law*, §4.1., 141(1986).
[1293] CL of 2015, *supra* note 179, art. 71; CGR, art. 30(14).
[1294] CL, art. 72; CGR, *supra* note 159, art. 30(15).
[1295] CL, art. 74, CGR, *supra* note 159, art. 30(16).

The CGR contains provisions addressing the duty of loyalty imposed upon directors in paragraph (2) of Article (29) where it states that "loyalty…is achieved when the Board member avoids transactions that may entail conflicts of interest and ensure fairness of dealing, in compliance with the provisions relating to conflict of interest in these Regulations."[1296] In addition, Chapter 6 of the CGR contains seven provisions governing conflict of interest.

The CGR fills the gap left in the CL of 2015 in that it specifically addresses the managers and employees' duty of loyalty, where they are required to refrain from activities that involve conflict of interest and self-dealing. Article (43) of the CGR requires the board of directors to initiate and apply a written policy "to deal with actual and potential conflict of interest situations which may affect the performance of Board members, the Executive Management or any other employees of the Company when dealing with the Company or other Stakeholders."[1297] This provision indicates that the policy must include clear procedures for disclosing conflicts of interest prior to commencing such activities. When the company has a transaction or enters into a contract with a "related party," the company must publicly disclose "without any delay of that contract or transaction if it equals to or exceeds 1% of the Company's total revenues."[1298]

Besides the requirement of disclosure involving conflict of interest, the CMA, through its power to regulate the capital market, imposes a duty to disclose information regarding ownership of securities and trading activities of directors, senior executives, and substantial shareholders. Article (90) of the CGR requires disclosure of information about

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[1296] CGR, *supra* note 159, art. 29(2).
[1297] *Id*. art. 43.
[1298] *Id*.

the ownership of directors, managers, and substantial shareholders in the company and any change in their interest during the fiscal year.[1299] The duty of disclosure regarding holding securities and trading activities of insiders is discussed in detail in the next part.

Summary

This part endeavors to answer the question of the legal status of corporate insiders in Saudi Arabia and why they are subject to restricted rules and regulations regarding their securities ownership and trading activities. This part reveals that the nature of the legal status of directors and managers is based on two principles: agency authorization, and trustee or fiduciary possession. This result is derived from Islamic law as the resort for judges when the statute is silent about the issue. Directors and managers are also subject to restricted duties and several obligations to refrain from abusing their power for their personal advantage. Abuse of powers includes self-dealing and corporate opportunity, or to wrongfully disclose confidential information to others without a legitimate business purpose.

Although the concepts of the principal-agent relationship and the fiduciary principles are recognized by classical Islamic jurisprudence and applied within the CL of 2015 and CGR, the notion of fiduciary obligations and self-restraint and accountability is relatively new to listed companies because of the novelty of governing the subject of corporate governance by regulations that involve governmental enforcement. The

[1299] Article 90 of the CGR requires the Board to "the Board's operations during the last fiscal year and all factors that affect the company's business. The report shall include, according to this Article, several mandatory information related to the Board members and description of their duties and responsibilities. The report must also include a discerption of any interest in a class of voting shares held by major shareholders, and "any interest, contractual securities or rights issue of the Board members, Senior Executive and their relatives on shares or debt instrument of the company or its affiliates, and any change on these interest or rights during the last fiscal year." *Id*. Article 45(b)(2) of the LR of 2017 has Similar provision of Article 90 of the CGR. *Supra* note 159.

determination of the legal status of corporate insiders as being subject to fiduciary principles helps to understand why corporate insiders are regulated by securities laws. In particular, it explains why corporate insiders are subject to public disclosure requirements and are criminally prohibited from trading on inside information or disclosing it to others to trade. The regulations of Saudi Arabian corporate insider trading are discussed below.

Part 2. Regulations Governing Legal Corporate Insiders' Trading

Introduction

Companies' insiders are in a sensitive position within the company because they either have managing control or control stock in the company and often have both powers. Therefore, insiders are subject to restricted legal trading regulations where their special position grants them access to sensitive price information about the company and its business operations. Thus, they are considered as a special class of traders.[1300] The CML and its implementing regulations state that companies' insiders have a duty to publicly disclose their trading activities and securities ownership.

This part identifies the duty to disclose insiders' trade transactions and securities ownership in Saudi Arabia. It starts with an examination of the ownership structure in the Saudi stock market, and then analyzes of the concept of disclosure of insiders' trades. This part then examines and assesses the related regulatory provisions of trading disclosure and the lock-up periods imposed upon directors and senior executives.

Ownership Structure of the Saudi Stock Market

Listed companies' insiders have restricted trading regulations because of their sensitive position inside the company; however, insiders are legally allowed to trade on their company's stock, except when specifically prohibited.[1301] In Saudi Arabia,

[1300] *See Cohen et al*, *supra* note 294, 1009; Khalid Saad Al-habshan, *Issues Involving Corporate Transparency in the Saudi Capital Market*, Public Administration Research; Vol. 6, No. 2, 32 (2017), available at: http://dx.doi.org/10.5539/par.v6n2p21; Abdulrahman Y. Baamir, *Issues of Transparency and Disclosure in the Saudi Stock Market*, 22 Arab L.Q., 72 (2008).
[1301] *Baamir*, at 74.

companies' insiders have business control and direct or indirect stock control over a large number of listed companies on the capital market. The available data on the Saudi capital market show that the ownership of listed companies is highly concentrated, and the companies are controlled by a small number of investors. In most instances, listed companies are either government-owned or family-owned.[1302]

The Saudi Arabian government owns 37.14 percent of the total market value of stocks in the Saudi stock market, which equals S.R.615 billion ($164 billion).[1303] This percentage of ownership makes the Saudi Arabian government the largest investor in the Saudi capital market.[1304] In fact, the Saudi government owns 45 percent of the total capital of the 20 largest listed companies in the Saudi stock market in the banking, petrochemical, telecommunication, and electricity sectors.[1305] The Saudi government owns their shareholdings through three public agencies: (1) the Public Investment Fund; (2) the General Organization for Social Insurance; and (3) the Public Pension Agency. The Public Investment Fund is the largest investor in the Saudi stock market. They own substantial shareholdings in more than 20 listed companies ranging from 5.4 percent to 70 percent of the total outstanding shares of these companies with a total market value of $131.6

[1302] AlKahtani, *supra* note 1289, at 177.
[1303] Ikrami Abdullah, *Airtifae Malakiat Al-Hukuma Al-Saudia fi Al-Ashum Al-Mahaliya e'la 37.1 %* [Saudi Government's Shares in Domestic Equity Rises to %37.1], Aleqtisadiah Newspaper, (Oct 16th, 2017) (Ar). http://www.aleqt.com/2017/10/15/article_1267351.html.
[1304] The Saudi Government owns most of the stocks through three agencies (1) The Public Investment Fund; (2) The Public Pension Fund; (3) the General Organization for Social Insurance. In addition, the Saudi Government owns shares directly in The Saudi Electricity Company worth $28.8 billion. *See Forbes Middle East, The Top 25 Investors in TADAWUL, Forbs* [Forbs Middle East] (August 2017), *https://www.forbesmiddleeast.com/en/list/top-25-investors-tadawul-stock-exchange/*.
[1305] Fadal Al-Buainain, *20 sharikat tamtalik Al-Hukuma 45 % min rasmaliha murashahat lel' khaskhasah* [*20 Companies Candidate for Privatization That The Saudi Government Owns 45% of their Capital*,] Okaz Newspaper, (April 20, 2014), https://www.okaz.com.sa/article/917274.

billion.[1306] The General Organization for Social Insurance is the second largest investor in the market with substantial shareholdings in 30 listed companies ranging from 5.7 percent to 35.12 percent with a total market value of $28.8 billion. The Public Pension Agency is the third largest investor in the market, as a substantial shareholder in 19 listed companies ranging from 5.27 percent to 23.79 percent of the total outstanding shares with a total investment worth $12.8 billion.[1307] In addition to large shareholding ownership in the Saudi stock market, the shares held by the Saudi government are not available for trading in the general market but they are held for long-term investment return purposes.[1308] In particular, the Saudi government has stock control over large companies, such as the Saudi Telecommunication Company (STC),[1309] and the Saudi Basic Industries Corporation (SABIC).[1310] These non-floated shares held by the Saudi government eliminate the possibility of rotation of control. Therefore, the Saudi government retains the right to elect a great number of board of directors members represented in many companies listed in the stock market.[1311]

[1306] *Kam yablugh Al-ayed alsanawi le Sinduq Al-Aistithmarat Alama min Al-sharikat Al-Saudia Al-Mudraja fi Al-Swuq Al-Saudi?* [Exclusive from Argaam Newspaper, *How Much is the Return of the Public Investment Fund from the Listed Companies*, (Nov 17, 2016), *https://www.argaam.com/ar/article/articledetail/id/454988*; *Abdullah*, *supra* note 1303; *Forbes Middle East*, *supra* note 1304. The investment value of the Public Investment Fund increased from $121.1 billion to $131.6 after the Saudi government transferred its equity ownership in the Saudi Electricity Company to the Public Investment Fund on September 17, 2017. *See id*; *Al-Saudia lil kahraba'" Tu'lin an Tasjil Al'Ashum Al-Mamlukat lil Hukumat fi ras mal alsharikat fi muhafazat sunduq Al-Aistithmarat Alama* [Saudi Electricity Company Announces the Registration of Government-Owned Shares in the Company's Capital in the Public Investment Fund Portfolio], Argaam Newspaper, (Sep 17, 2017), https://www.argaam.com/ar/article/articledetail/id/505109.

[1307] *Forbes Middle East, supra* note 1304.

[1308] FARAJ, *supra* note 1234, at 75.

[1309] The Saudi government owns 83.77 % of STC total outstanding shares. The Public Investment Fund owns 70 % of the STC, the General Organization for Social Insurance owns 7 %, and the Public Pension Agency owns 6.77% of STC. These data are derived from the official website of the Saudi stock market [www.Tadawul.com.sa/].

[1310] The Saudi government owns 75.7% of SABIC. The Public Investment Fund owns 70%, and the General Organization for Social Insurance owns 5.7% of SABIC. *See id.*

[1311] FARAJ, *supra* note 1234, at 75.

In addition to the Saudi government as the largest investor in the Saudi stock market, a few families and individual investors also hold large equity ownership and exercise control over many other listed companies.[1312] This demonstrates that the notion of concentrated control in the hands of a few shareholders is the dominate practice for many listed companies in the Saudi stock market.[1313] Alqhatani reported that 20 percent of the total outstanding shares of more than 22 listed companies in the Saudi stock market are owned by a single family or by only a few shareholders.[1314] In addition, the market data of substantial shareholders in Saudi listed companies show that 81 individuals out of 282 substantial shareholders[1315] own shares worth S.R. 151.15 billion ($40.3 billion) and comprise 7 percent of the market value of the total listed shares in the Saudi stock market.[1316] However, only 22 substantial shareholders own shares worth S.R.1 billion ($375 million) or more. Prince Alwaleed Bin Talal Al Saud is the largest investor after the Saudi government with investments worth $9.6 billion. Prince Sultan bin Mohammed bin Saud Al Kabeer is next with investments of approximately $4.4 billion. The other 20 investors own investments ranging from approximately $1 billion to $306 million[1317]

The available market data show that one-third of the listed companies have at least two directors from the same family.[1318] In addition, according to a media report, three families have 41 percent of the membership on boards of directors of 68 listed companies.

[1312] AlKahtani, *supra* note 1289, at 179.
[1313] *Id*, at 181.
[1314] *Id*, at 179.
[1315] The 281 substantial shareholders other than individual investors include local and international governmental and private funds and organizations. *See Abdullah*, *supra* note 1303.
[1316] *Talal Al Sayah, 151 Milyaraan He'sas Kibar Al-Mulak Al'Afrad fi Al'Ashum Al-saudi* [151 billion portion equity of the biggest shareholders, Aleqtisadiah Newspaper, (May 25, 2015), *http://www.aleqt.com/2015/05/25/article_960109.html*.
[1317] *Forbes Middle East*, *supra* note 1304.
[1318] AlKahtani, *supra* note 1289, at 179.

Members from the Al-Saud, Al-Issa, and Al-Rajhi families have been named 89 times on the boards of directors of listed companies. Members from the Al-Saud family tops the list with 34 memberships, members from the Al-Rajhi family have 28 memberships, and members from the Al-Issa family have 27 memberships on boards of directors of listed companies. For instance, the members from the Al-Rajhi family own and control Al-Rajhi Bank and Al-Rajhi Insurance. In addition, some members of the Al-Rajhi family including their cousins have substantial shareholding ownership and control over Albilad Bank, Najran Cement, Arabian Cement, Saudi Cement, Yanbu Cement, NADEC, Tabuk Agriculture, and Tabuk Advanced Companies.[1319]

To reduce concerns about a negative effect because of the large ownership and control held by companies' insiders, and to provide necessary protection concerning investor confidence in the Saudi capital market, the CML and its implementing regulations have adopted a public disclosure policy as an overarching principle governing insider trades and securities ownership in the Saudi stock market.[1320] In addition to requiring disclosure, the CMA imposes trade restrictions "lock-up periods" on directors and senior executives of listed companies preceding the public announcements of the quarterly and annual financial results of listed companies.[1321] The following section discusses the concept of public disclosure and the regularity provisions governing the public disclosure of insider trades and block-out periods imposed on directors and senior executives.

Concept of Public Disclosure of Insider Trades

[1319] Maaal.com, bial'Asma'.. 3 ayilat Tastahwidh alaa 41% min majalis 'edarat Al-sharikat Al-musahama [*3 families hold 41% of the boards of directors of joint stock companies*], (Mar 18, 2015), http://www.maaal.com/archives/55910.
[1320] *Beach*, *supra* note 153, at 338.
[1321] *See* Al-habshan, *supra* note 1300, at 32; *Baamir*, *supra* note 1300, at 74.

Public disclosure of insider trades is regulated to accomplish two goals, in general. The first goal is to use the public discourse system as a tool to deter trading violations based on inside information that is available to insiders but is not yet available to the public.[1322] When insiders are required to disclose their trading transactions, the likelihood that insiders will be noticed and punished for trading on inside information increases. Therefore, insiders are more likely to refrain from trading on inside information that they have access to because of their position inside the company.[1323] As a result, the disclosure requirement gives the CMA a useful tool to investigate insider trades to deter insiders from abusive trading.[1324]

The second goal of the imposition of trading disclosure is to provide the public with up-to-date and reliable trading information as part of an efficient stock market.[1325] The disclosure of insider trades to the public helps investors make informed investment decisions in two ways. First, it draws their attention to the possibility that such trading was based on inside information, which may imply that the market price of the related security is inaccurate.[1326] In addition, since insider trades could be motivated by reasons other than inside information, such as liquidity or diversification,[1327] public disclosure gives investors valuable information about the prospect of the company.[1328] Investors, in turn, use the disclosed trading information to adjust their bidding to related securities that they believe reflect the newly disclosed information.[1329]

[1322] COX ET AL, *supra* note 7*,* at *944*; *Fried*, *supra* note 285, at 810.
[1323] *Fried*, *id*.
[1324] *Beach*, *supra* note 153, at 338.
[1325] *Id*, at 338-340.
[1326] *Fried*, at 810.
[1327] *Cohen et al*, at *supra* note 294, at 1010.
[1328] COX ET AL, *supra* note 7, at 944.
[1329] *Fried*, at 810.

Public disclosure of an increase or decrease in substantial shareholders' ownership helps shareholders protect their interest in the company by making necessary decisions to deal with the new development. An increase or decrease in the equity ownership of substantial shareholders may also lead to a change in the direction of the company and its business management and operation.[1330] For example, a new substantial shareholder may seek changes or amendments to the company's articles of association or to the board of directors. Such a potential change in equity ownership justifies the need for public disclosure about any changes in equity ownership regarding substantial shareholders.[1331]

Public Disclosure of Corporate Insider's Securities Ownership and Trading Transactions

The CML does not expressly require insiders of listed companies to disclose their ownership or trading activity. In general, Chapter 7 of the CML requires listed companies to periodically disclose information or to promptly disclose material developments.[1332] Listed companies are required to disclose certain information when they conduct an initial public offering,[1333] and they are required to continue to disclose financial and managerial information in the secondary market.[1334] The continuous disclosure system has two mandatory disclosure regimens. According to Article (45) of the CML, listed companies are mandated to disclose certain information in quarterly and annual reports including their financial condition and updates on financial and managerial developments.[1335] Article (45) requires listed companies to disclose in their annual reports "information regarding

[1330] *Baamir*, *supra* note 1300, at 71.
[1331] *Id*.
[1332] CML, *supra* note 152, art. 45, and 46.
[1333] *Id*. arts. 40, and 42.
[1334] *See Beach*, *supra* note 153, at 338; *Gouda*, *supra* note 161, at 124-26.
[1335] CML, *supra* note 152, art. 45.

members of its board of directors, executive officers, senior staff and substantial investors or shareholders as required under the rule of the Authority."[1336] Listed companies are also required to promptly disclose any new material development.[1337] Chapter 7 of the CML, however, was written in generalities and the content of these reports are only partly stated. This implies that the legislature intentionally left gaps in Chapter 7 by following the goals of applying the general policy of the CML: professionalism and administrative independence.[1338]

The CML has granted the CMA vast rulemaking power to regulate and rule the public disclosure system whether by adding or reducing the content of such disclosure or having authority to develop the forms of disclosure.[1339] Article (45) of the CML clearly states this rule by requiring listed companies to disclose in addition to their financial status, "any other information as required by the rules of the Authority."[1340] It also requires listed companies to disclose in their annual reports "any…information as may be required by the rule of the Authority as it deems necessary to assist investors and their advisers in making a decision to invest in the issuer's Securities."[1341] The disclosure rulemaking authority of the CMA is also emphasized by Article 46 which authorizes the CMA to request the issuer "to provide any information or data pertaining to such party and the issuing party shall provide the same within the period of time specified in the request."[1342] The CML also has granted the Saudi Stock Exchange, represented by its board of directors, the authority to

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[1336] *Id*. art. 45(b)(2).
[1337] *Id*. art. 46. *See Beach*, *supra* note 153, at 338; *Gouda, supra* note *161*, at 154.
[1338] *Beach*, *supra* note 153, at 339.
[1339] *Id*.
[1340] CML, *supra* note 152, art 45(a)(4).
[1341] *Id*. art. 45(b)(4).
[1342] CML, *supra* note 152, art. 46(b).

propose regulations and rules related to the operation of the Exchange.[1343] The authority power granted to the board of directors includes the power to issue regulations imposing "immediate and timely publication of information regarding transactions executed in Securities traded on the Exchange" and requiring "issuers of Securitas, shareholders and members to disclose such information to the Exchange as the Exchange deems necessary."[1344] These proposed regulations and rules must be approved by the board of the CMA before becoming effective.[1345]

In 2004, the CMA used its rulemaking authority by issuing the Listing Rules of 2004 (LR of 2004), which contained rules governing the listing of securities and the disclosure system.[1346] Article 45 of the LR of 2004 regulated the disclosure of insider trades.[1347] It required substantial shareholders, directors and senior executives to disclose their securities ownership in the issuer once they occupied such capacities, and when there was a significant change in their ownership percentage.[1348] Directors, senior executives, and substantial shareholders were also required to disclose to the CMA and the issuer any change in their previously disclosed ownership objective. However, LR of 2004 is no longer an effective law and Article 45 is no longer applied.

On December 31, 2017, the CMA board issued a resolution enacting a new regulation called the Rules of Offering Securities and Continuing Obligations

[1343] *Id*. art. 23(a).
[1344] *Id*. art. 23(a)(3).
[1345] *Id*. art. 23(b).
[1346] The Listing Rules [LR of 2004], Board of the Capital Market Authority's resolution No. 3-11-2004, dated 20/8/1425H (corresponding to April 10th, 2004), amended by to the Resolution No. 1-64-2016, dated 19/8/1437H (Corresponding to May 26th, 2016), art. 45.
[1347] *Id*.
[1348] *Id*. art. 45(a)(3)(4).

(ROSCO).[1349] The CMA also approved the Listing Rules (LR of 2017) that had been issued by the Saudi Stock Exchange (Tadawul).[1350] According to CMA's announcement, the ROSCO replaced the Offer of Securities Regulations of 2004 and the LR of 2004.[1351] The enacted regulations became effective on April 1, 2018.[1352] Article (68) of the ROSCO titled "Restriction on Dealings," and Article (33) of the LR of 2017 are the articles containing disclosure requirements on insider trades. However, Article (68) of the ROSCO solely requires disclosure from substantial shareholders. In addition, Article (90) of the CGR requires the board of director of a listed company to disclose, in the annual report, the name of the directors, senior executives and substantial shareholder's ownership and interest in securities of the listed company. Article (69) of the ROSCO imposes lock-up periods upon directors and senior executives during the periods preceding or following the announcement of quarter and annual reports. These articles are discussed below.

Substantial Shareholders' Regulatory Disclosure Requirement

Article (68) of the ROSCO and Article (33) of the LR of 2017 governs the disclosure of substantial shareholders. According to Article (68) of the ROSCO, substantial shareholders must disclose once they become a substantial shareholder and must subsequently disclose to the Exchange any change from their initial disclosure.[1353] Paragraph (a) of Article (68) obliges persons who own or is interested in 5 percent or more

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[1349] ROSCO, *supra* note 157.
[1350] LR of 2017, *supra* note 158.
[1351] Capital Market Authority, CMA Board Issues its Resolution Approving the Rules of Offering Securities and Continuing Obligations and Approving Listing Rules, (Dec 31, 2017), *available at* https://cma.org.sa/en/Market/NEWS/Pages/CMA_N_2345.aspx.
[1352] *Id*. (CMA indicates that "the Rules of Offering Securities and Continuing Obligations aims to regulate the offering of securities in Saudi Arabia. It includes the conditions of the offer of securities, identifies the requirements of listing and offering, and the conditions and requirements of capital changes. In addition to regulating the continuing obligations on issuers whom their securities are listed…") *id*.
[1353] ROSCO, *supra* note 157, art. 68

of any class of voting shares or convertible debt instruments of an issuer deemed "substantial shareholders."[1354] Substantial shareholders are also required to disclose a list of persons who have interest in the shares or convertible debt instrument owned or controlled by the substantial shareholders.[1355] A person is considered to have interest in shares or convertible debt instruments of an issuer when such securities are owned or controlled by: "1) a relative of that person; 2) a company controlled by that person; or 3) any other person with that person has agreed to act in concert to acquire an interest in or exercise voting rights in the shares or in the convertible debt instruments of the issuer."[1356] Substantial shareholders are required to disclose three types of information in their initial disclosure: (1) the names of all persons who own or have the right to dispose the related securities; (2) detailed information about the ownership process; and (3) detailed information about loans or any other financial support received from any other person.[1357]

In addition to imposing a duty to disclose to the CMA when they become owners of 5 percent or more, substantial shareholders must update their initial disclosure to the Exchange.[1358] Substantial shareholders are required to disclose any change to the list of the persons that was previously disclosed to the CMA.[1359] This duty to update is triggered when a new person is added to the list or a person who was previously included in the list is excluded.[1360] Article 33 of the LR of 2017 requires substantial shareholders to disclose

[1354] *Id*. art. 68(a).
[1355] Id. art. 68(b).
[1356] *Id*. art. 68(c)
[1357] *Id*. art.68(d).
[1358] *Id*. art. 68 (b).
[1359] *Id*.
[1360] *Id*.

their holding or interest securities to the Exchange for public disclosure through special electronic filing.[1361]

Directors' and Senior Officers' Regulatory Disclosure Requirement

In the wake of enacting of ROSCO, directors and senior executives are no longer required to disclose their securities ownership and trading activities to the CMA.[1362] However, the Exchange is required to disclose directors and certain executives' securities ownership to the public. In April 2016, the CMA issued a decision requesting that the Saudi Stock Exchange (Tadawul) shall disclose the ownership percentage for the board members, the chief executive officers (CEO) (or the top executive at the company), and the chief financial officer (CFO) of listed companies, in addition to the substantial shareholders of an issuer.[1363] The listed companies are now required to electronically file the ownership

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[1361] LR of 2017, *supra* note 158, art. 33(a) (This Article states that a "person required to notify its holding or interest in listed securities to the Exchange under the applicable Implementing Regulations, must make such notification to the Exchange through the designated electronic system or any other means determined by the Exchange.") *Id*.

[1362] For a question on whether there are any legal provisions within the CMA's implementing regulations, the student was given the following email response: "After repealing the Listing Rules of 2004 governing the disclosure of directors and senior officers trading activities, the Capital Market Authority states that the Rules on the Offering of Securities and Continuing Obligations effective since April 1, 2018, has replaced the Listing Rules of 2004. The Article 68 of the Rules of Offering and Continuing Obligations now only addresses the dealings of substantial shareholders and does not impose any duty to disclose upon directors or senior officers in relation to their own securities." (*See* email from the Capital Market Authority, CMA info, to student, Sep 10, 2018, 2:57 AM, on file with the student). The same question was emailed to Tadawul. The Tadawul referred to part 9 of the Corporate Governance Regulations of 2017: Disclosure and Transparency, Article 92: Disclosure by the Board. (*See* email from the Saudi Stock Exchange "Tadawul," Customer Service to the student, Sep 8, 2018, 8:34 PM, on file with the student). Article 92 of the Corporate Governance Regulations of 2017 requires that the board must regulate the disclosures of the directors and executive management. The Board shall 1) maintain "a register for the disclosure of the Board members and the Executive Management and updating it regularly based on disclosures required as per the Companies law, the Capital Market Law and their implementing regulations; and 2) mak[e] [] such register available for review by the Company's shareholders free of charge." However, Tadawul's answer does not answer the student's question and makes the subject of directors and senior executive trading disclosure more confusing because Article 92 bases the disclosure on what is required by the Companies Law, the Capital Market Law and their implementing regulations." The question was which legal provisions govern the disclosure of directors' and senior executives' trades. Therefore, Article 92 does not contain the answer.

[1363] The Saudi Stock Exchange [Tadawul] Announces the Implementation of CMA Resolution Pertaining to Investor's Ownership Disclosure Mechanism, Tadawul's Website, (April 11, 2016) *available at*: https://bit.ly/2O61cj6.

percentage of the related persons on Tadawul's website.[1364] In addition, Article (33) of the LR of 2017 requires the same disclosure obligation. It states that "the Exchange shall, on a daily basis, publish an updated list which includes the direct ownership of directors, the CFO, and the CEO (or the highest executive position) in the issuer's listed shares."[1365]

The available data show that listed companies are responsible for disclosing the ownership percentage of directors and senior executives to Tadawul through electronic filing. A caveat on Tadawul's website under each published list of directors' securities ownership states that:

> The listed company (Publisher) shall be responsible for the accuracy of the published information pertaining to the ownership of the Board of Directors, Chief Executive Officer or highest executive position, and the Chief Financial Officer. The listed company shall also be responsible for updating this information thereof. Therefore, the Saudi Stock Exchange (Tadawul) shall not be liable for the information contained therein, nor for any consequences that may result from the said information."[1366]

Time to Disclose the Ownership of Listed Companies' Insiders

Article (68) of the ROSCO states that when a person has ownership or interest in 5 percent or more of any class of voting shares or convertible debt instruments of an issuer, the person must notify the CMA by the end of the third day following the execution of the transaction or the occurrence of the event that results in such ownership or interest.[1367]

[1364] *Id*.
[1365] LR of 2017, *supra* note 158, art. 33(e).
[1366] *See* Tadawul's website, *available at* https://bit.ly/2D0lTMu.
[1367] ROSCO, *supra* note 157, art. 68 (a).

Since substantial shareholders are also required to disclose the list of persons that have an interest in the shares or convertible debt that substantial shareholders own or control, substantial shareholders are required to disclose by the end of the third day following any event that results in the inclusion or exclusion of a person on that list.[1368] Article (33) of the LR of 2017 requires the disclosure or the notification of ownership or change of an ownership, which is to be submitted to the Exchange, no later than three days following the event that triggers the duty to disclose.[1369] Article (33) also requires the Exchange to publish on a daily basis an updated list of direct ownership of directors, and the CEO and the CFO in the issuer's listed shares.[1370]

Based on Article (68) of the ROSCO and Article (33) of the LR of 2017, it can be said that substantial shareholders, directors, and senior executives are given a flexible timeframe to disclose their identity and ownership percentage. Instead of disclosing by the end of the same trading day based on Article (45) of the repealed LR of 2004, insiders legally have three trading days to report their identity and securities holdings. These new regulatory articles grant investors more flexibility to invest with anonymity for three trading days. Some commentators have argued that requiring disclosure from owners of 5% or more of an issuer's securities is a disadvantage that comes at the expense of getting more liquidity into the market.[1371] Large investors typically want to invest without public knowledge about their investments, particularly their partners or creditors.[1372] However, when the disclosure paradigm was evaluated by the CMA by the end of 2017, the CMA

[1368] *Id*. art. 68 (b).
[1369] LR of 2017, *supra* note 158, art. 33 (b).
[1370] *Id*. art. 33 (f).
[1371] Mahayni, *supra* note 160, at 155.
[1372] *Id*.

maybe found that the previous requirement of disclosure had put unwarranted restrictions on corporate insiders and discouraged investors from bringing more capital and liquidity to the Saudi capital market.[1373] However, instead of increasing the security ownership percentage that would trigger disclosure, the CMA simply delayed the disclosure time from the same day to three days.[1374] The most likely reason for this delay of disclosure can be imputed to the new trade settlement cycle system that was applied in 2017. TADAWUL implemented the T+2 settlement cycle instead of T+0, in which the ownership transfer date is two days after the transaction day.[1375] Therefore, Article (68) of the ROSCO took into consideration that the time of settlement or transfer of ownership is three days from the date of the transaction. Therefore, it grants a three-day period for disclosure after transferring ownership.

Despite the goal of enhancing the financial sector by increasing liquidity or accommodating the new settlement cycle system, the change from a one-day period to a three-day period for insiders' disclosure may unwittingly help large shareholders make more profits by trading based on inside information or even without inside information but by taking advantage of late disclosure obligation.[1376] Therefore, public investors may characterize the late trading disclosure as a sign of a low efficient market imputed to the Saudi stock market because up-to-date trading information is one of the bases of efficient markets. When companies' insiders have three days instead of one day to trade without

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[1373] *Id*. (Mahayni argues that 5% shareholding is insufficient to control the company or affect the trading value of the related shares. The author suggested that socio-economists should help CMA by calibrating the threshold that would attract investment by larger and small investors.) *Id*.
[1374] *See* ROSCO, *supra* note 157, art. 68; LR of 2017, *supra* note 158, art. 33(b).
[1375] *See* Sophie Baker, Saudi Stock Exchange to Shift to T+2 trading settlement Cycle, Pension& Investment, (March 24, 2017), https://www.pionline.com/article/20170324/ONLINE/170329911/saudi-stock-exchange-to-shift-to-t2-trading-settlement-cycle.
[1376] *See Fried*, at *supra* note 285, at 810.

disclosure, they will gain more profits without being disturbed by price adjustmenta that public investors may make.[1377] Some commentators have suggested that public disclosure shall be taken before even the time of the trade, in which securities professionals, broker/dealers, and public investors may have sufficient time to respond by adjusting their biddings to reflect the potential insider trading before it is commenced.[1378] This pre-trading disclosure requirement would help to reduce the profits that insiders may generate from trading on inside information and discourage them from doing so.[1379] In addition, it may help level the playing field between public investors and insiders where the public would know in advance that an insider is going to trade, and therefore, they could trade or refrain from trading based on informed investment decisions.[1380] However, delaying the disclosure time to a three-day period does not serve the policy of reducing the incentive of trading on inside information by corporate insiders.

<u>The Board of Director's Annual Report on the Securities Ownership of Insiders and Changes in Ownership during the Fiscal Year</u>

Article (90) of the CGR requires the board of directors of a listed company to disclose any information related to the board's operations in the previous fiscal year including all factors that affect the company's business.[1381] According to this Article, the report must include several types of information related to the directors and senior

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[1377] *See Fried*, *id*.
[1378] COX ET AL, *supra* note 7, at 944; Jesse M. Fried, *Reducing the Profitability of Corporate Insider Trading Through Pretrading Disclosure*, 71 S. Cal. L. Rev. 303 (1998).
[1379] Fried, *Id*. (Professor Jesse M. Fried has suggested that the best effective-cost plan to reduce profits gained from trading on inside information by corporate insiders is to require them to disclose in pre-trading bases, which would substantially reduce corporate insider trading profits as a group.) *Id*. at 306.
[1380] *Id*. at 313.
[1381] CGR, *supra* note 159, art. 90.

executives and a description of their duties and responsibilities. The report must include the "names, qualification, and experience of the board members and executives management,"[1382] as well as a description of the "composition and classification" of the directors, as follows: "Executive directors, Non-Executive Director, or Independent Director."[1383] The report must also include a description of any interest in a class of voting shares held by substantial shareholders[1384]and "any interest, contractual securities or rights issue of the Board members, Senior Executive and their relatives on shares or debt instrument of the company or its affiliates, and any change on these interest or rights during the last fiscal year."[1385]

The CGR places great emphasis on the disclosure of the remuneration of the directors and senior executives. Pursuant to Article (93) of the CGR, the board must disclose the policy and the mechanism that determine the remunerations of the board of directors and senior executives[1386] in its annual report under Article (90) of the CGR.[1387] It also requires the board to completely disclose, without any omission or misleading information, the remuneration granted to the directors and senior executives directly or indirectly.[1388] The report must reveal the nature of the remuneration, whether it was in the form of cash or not. If the remunerations were in the form of shares of the company, the report must also disclose the value of the shares in accordance with the market value of the

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[1382] *Id*, art. 90(2).
[1383] *Id*, art. 90(4).
[1384] *Id*, art. 90(25).
[1385] *Id*, art. 90(26).
[1386] *Id*, art. 93(a)(1).
[1387] *Id*, art. 93(a)(8).
[1388] *Id*, art. 93(a)(2).

shares on the due date.[1389] The board of directors is required to publicly disclose its annual report within three months from the end of the fiscal year.[1390]

Trading Restrictions on Directors and Senior Executives

Article (69) of the ROSCO imposes trading restrictions "lock-up periods" on directors and senior executives. According to this article, "the directors, senior executives or audit committee members of the issuer and any of their associates" are prohibited from trading in any securities of the issuer (1) during the 15 calendar days preceding the end of the financial quarter and until the date of the announcement of the reviewed interim financial statements of the issuer;[1391] and (2) during the 30 days preceding the end of the financial year and until the date of the disclosure of the audited annual financial statements of the issuer.[1392] Article (69) of the ROSCO provides an exception from the prohibition of trading during the lock-up periods. Directors, senior executives, and audit committee members of the issuer are allowed to trade during lock-up periods for "exercising the subscription's right in rights issues[1393] and the sale of such rights."[1394]

Article (34) of the LR of 2017 requires issuers to "provide the Exchange with the details of its directors, audit committee members, senior executives, and any of their associates in accordance with the form prescribed by the Exchange. The Exchange will

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[1389] *Id.*
[1390] ROSCO, *supra* note 157, art. 65.
[1391] *Id*. art. 69(a)(1).
[1392] *Id*. art. 69(a)(2).
[1393] The CMA defines rights as "an offer of additional shares to exciting shareholders which enables those shareholders to subscribe in proportion to their existing holdings." Capital Market Authority, Glossary of Defined Terms Used in the Regulations and Rules of the Capital market Authority [Glossary of Defined Terms], Issued by the Board of the Capital Market Authority, Resolution No. 4-11-2004, dated 20/8/1425H corresponding to Oct 4, 2004, and amended by resolution No. 1-7-2018, dated 1/5/1439H corresponding to Jan 18, 2018, https://cma.org.sa/en/RulesRegulations/Regulations/Documents/CMA_Glossary_en.pdf.
[1394] ROSCO, *supra* note 157, art. 69(b).

oversee their adherence to the lock-up periods imposed by the Rules on the Offer of Securities and Continuing Obligations."[1395] In addition, Article 33 of the Listing Rules states that the Exchange should publicly disclose the ownership percentage of persons subject to the lock-up periods.[1396]

It is worth noting that associates and related persons to the directors, senior executives, and committee members are also subject to the same ban from trading during the lock-up periods.[1397] The CMA defines a person who is related to directors and senior officers as (1) immediate family members, husband/wife and minor children; and (2) a company that a director or senior executive or any member of their immediate families have direct or indirect controlling interest in that company, which enables them to "vote or control the votes of 30 in percent of the voting rights in the general assembly…[or] appoint or dismiss directors having the majority of the voting rights in the board meetings..."[1398]

<u>Trading during Lock-Up Periods is Circumstantial Evidence of Trading based on Inside Information</u>

The underlying theory of the regulatory imposition of lock-up periods on trading by directors and officers on their company's stock can be based on the notion that they are more likely to be knowledgeable of or have access to inside information while preparing financial reports and before releasing them to the public.[1399] Article 45(c) of the CML considers the financial content and the management forecast of the quarterly and annual

[1395] LR of 2017, *supra* note 158, art. 34(c).
[1396] *Id*, art. 33(f).
[1397] *Id*. art. 34(c); ROSCO, *supra* note 157, art. 69.
[1398] Glossary of Defined Terms, *supra* note 1393.
[1399] Ari B. Lanin & Daniela L. Stolman, *Securities Enforcement-Building a Better Insider Trading Compliance Program,* Aspen Publisher, Vol 25, No. 3, 6 (2011), https://bit.ly/2QtDpeB.

reports to be confidential information.[1400] Therefore, before disclosing such information to the CMA, it is prohibited to disclose the information to any other persons "not bound by a confidentiality obligation and an obligation to protect such information."[1401] This prohibition of disclosing financial information before revealing it publicly along with the prohibition of trading before the disclosure clearly indicates that the goal is to prevent trading based on inside information and to assure investors that the market is safe.[1402]

Although trading during these lock-up periods is not by itself considered illegal corporate insider trading,[1403] the trading time is circumstantial evidence which may indicate that the trading is based on inside information. In 2010, the ACRSD ratified the CRSD's decision to convict a director of a company for trading on inside information related to the fourth quarter report of the company and during a lock-up period.[1404] The Appeal Committee stated that a director's trading during the lock-up period "indicates that the [director] was aware of the fact that he possesses [] inside information and was willing to use this information" to avoid market risks. Therefore, the requisite state of mind can be demonstrated by the fact that the director traded during a lock-up period.[1405]

Summary

This part explains the regulations pertaining to corporate insider trading in terms of the requirement of public disclosure and the imposition of lock-up periods preceding the

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1400 CML, *supra* note 152, art. 45(c).
1401 *Id*.
1402 *See Beach*, *supra* note 153, at 341.
1403 Paragraph (d) of Article 34 of the Listing Rules of 2017 states that: "The Exchange shall, when it becomes aware that any person mentioned in paragraph (c) of this Article is not in compliance with the lock-up periods imposed by the Rules on the offer of Securities and Continuing Obligations, notify the Authority of the suspected breach in order for the Authority to take the appropriate steps." LR of 2017, *supra* note 158, id.
1404 The Appeal Committee for the Resolution of Securities Disputes (hereinafter ACRSD), Decision No.229/ L.S/ 2010 of 1431 H, season of 15/6/1431H (corresponding to May 29, 2010), P.5, available *at*: http://www.crsd.org.sa/en/AppealsCommittee/Decisions/Documents/229-31E.pdf.
1405 *Id*.

public disclosure of the issuer's financial periodical results. This part shows that the scope of corporate insiders who are subject to the disclosure requirement includes directors, senior executives, and substantial shareholders who own 5 percent or more of the equity security of the issuer. These insiders are required to publicly disclose their securities ownership and trading transactions by the end of the third day following the transaction. Corporate insiders and senior executives are also prohibited from trading during lock-up periods—15 days before the end of the financial quarter until the announcement—and 30 days before the end of the fiscal year until the announcement of financial result.

The definition of insiders under the Saudi Arabian regulations includes persons who possess actual control or voting control over equity security. Therefore, shares that are owned by family members or controlled companies are attributed to these insiders whether by the requirement of public disclosure upon substantial shareholders, or the prohibition from trading during lock-up periods by directors and senior executives. This part shows the importance of public disclosure and transparency that the CMA has sought to apply in the Saudi stock market. However, delaying the time of disclosure from a one-day period to a three-day period was not the right approach to take to accomplish the goal of public disclosure.

After a discussion about the regulatory restrictions upon corporate insiders, the next part discusses the prohibition imposed upon corporate insiders from trading on inside information that is unknown to the public.

Part 3. Illegal Corporate Insider Trading Regulations

Overview

While insiders are legally permitted to trade in their companies' stock, the CML imposed a permanent ban on trading after insiders obtain inside information that has not yet been disclosed to the general public.[1406] The ban of illegal corporate insider trading in the Kingdom of Saudi Arabia is a statutory prohibition included in Chapter 8 of the CML in addition to another provision related to the prohibition of manipulative activities to protect public investors from unfair and abusive market activities.[1407] Article (50) of the CML, which prohibits illegal corporate insider trading, was drafted in consideration of recent international legal developments regarding the regulations of illegal corporate insider trading.[1408] Article (50) reads as follows:

> (a) Any person who obtains, through family, business or contractual relationship, inside information (hereinafter an "insider") is prohibited from directly or indirectly trading in the Security related to such information, or to disclose such information to another person with the expectation that such person will trade in such Security.
> Insider information means information obtained by the insider and which is not available to the general public, has not been disclosed, and such information is of the type that a normal person would realize that in view of the nature and content of this information, its release and availability would have a material effect on the price or value of a Security related to such information, and the insider knows that such information is not generally available and that, if it were available, it would have a material effect on the price or value of such Security.
> (b) No person may purchase or sell a Security based on information obtained from an insider while knowing that such person, by disclosing such insider information related to the Security, has violated paragraph (a) of this article.
> (c) The Authority has the power to establish the rules for specifying and defining the terms provided for under paragraphs (a) and (b) of this Article, and such acts or practices which the Authority deems appropriate to exempt them from their application, as may be required for the safety of the market and the protection of investors.[1409]

[1406] CML, *supra* note 152, art. 50.
[1407] *See* Saad Ali Aljloud, The Law of Market Manipulation in Saudi Arabia, 31 (2016), https://bura.brunel.ac.uk/bitstream/2438/14644/4/FulltextThesis.pdf%20.
[1408] *See Beach*, *supra* note 153; *Gouda*, *supra* note 161, at 156.
[1409] CML, *supra* note 152, art. 50(a), (b), and (c).

Article (50) of the CML includes six rules. First, it determines that the prohibited conduct includes trading after obtaining inside information or disclosing the information to another with the expectation that the other person will trade on such information. Second, it defines who is an insider to include not only traditional companies' insiders but also any person who obtains the information through a family, business or contractual relationship. Third, it defines the term "inside information" to mean information that has not been publicly disclosed or otherwise made available in which the information, if it were made public, would have a material impact on the price or value of the related security. It also requires that the insider must have knowledge about the nature of the information and its materiality. Fourth, it prohibits outsiders from trading based on inside information obtained from insiders if they have knowledge that the disclosure was in violation of the insider's duty under Article (50) not to disclose inside information to another with the expectation that the other person will trade on such information. Sixth, Article (50) states that it gives the CMA the rulemaking authority to specify and define the terms provided and to exempt some practices from the coverage of the article as the CMA believes necessary for the safety of the market and the protection of investors.[1410]

In November 2004, the CMA used its rulemaking authority under Article (50)(c) to more specifically define the rules and terms stated in paragraphs (a) and (b) of Article (50).[1411] The CMA issued three articles under the Market Conduct Regulations of 2004 (MCR),[1412] which were designed to fulfill three purposes. Article (4) of the MCR defines when an insider is deemed to have traded in the related security and what a security

[1410] *See Id*; *Beach, supra* note *153*, at 344.
[1411] MCR, *supra* note 156, arts. 4, 5, and 6.
[1412] *Id*.

involves. It also defines who is an insider and the meaning of inside information. Article (5) of the MCR concerns the prohibition of the disclosure of inside information to outsiders and what is deemed unlawful disclosure. Article (6) of the MCR provides a general prohibition from engaging in insider trading against insiders and outsiders.

This part seeks to examine the regulations of illegal corporate insider trading in Saudi Arabia by discussing two main questions: Who is subject to the prohibition of illegal corporate insider trading as either an insider or outsider? and What does inside information mean? This part starts with a discussion of the development of illegal corporate insider trading regulations in Saudi Arabia. It then goes on to determine the Saudi Arabian theory of prohibiting illegal corporate insider trading. Next, this part defines who is subject to the prohibition of trading after obtaining inside information. In particular, it examines the statutory definition of the term "inside information" and what an insider must know while trading on such information to render the trading illegal.

Development of the Regulations of Illegal Corporate Insider Trading

a. Before Enacting the Capital Market Law

The first Saudi Arabian attempt to statutorily address the prohibition of trading on inside information by company insiders was in 1997.[1413] Between 1984 (when the first

[1413] Awwad Saleh Awwad, legal Regulation of the Saudi Stock Market Evaluation and Prospects for Reforms, University of Warwick institutional repository, 275 (2000), https://core.ac.uk/display/1383620/tab/similar-list.

official stock market was established) and 1997,[1414] trading on inside information by company insiders in the stock market was not directly statutorily prohibited and insiders were not statutorily prohibited to trade on inside information even if the trading was a breach of their fiduciary/trustee position.[1415] The Saudi Arabian Companies Law of 1965 (CL)[1416] attempted to partially prevent insiders from exploiting inside information.[1417] Article (72) of the CL stated that: "Members of the Board of Directors should not disclose to the stockholders or to third parties outside the meeting of the General Assembly any confidential information they obtain because of their performance of the management of the company. Otherwise, they are deemed liable and subject to removal and liability for damages."[1418] However, prohibiting insiders from illegitimately disclosing inside information but not prohibiting them from trading on such information by themselves was an adequate sign that the prohibition fell short of addressing the issue of illegal corporate

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[1414] The regulatory oversight and control of the Saudi Arabian stock market before establishing the Capital Market Authority in 2003 was distributed between multiple regulatory bodies. The primary market and some matters related to the secondary market were enforced and supervised by the Ministry of Commerce by applying the Companies Law of 1965. *See infra* note 1421. The secondary market was regulated and governed by the Saudi Arabian Monetary Authority (SAMA). In addition, stock market oversight was by the Ministerial Committee, which was the highest regulatory power in the capital market. It was mostly concerned about assessing the performance of the Ministry of Commerce and SAMA in regulating the stock market and joint stock companies listing their shares in the exchange. *See* Awwad, *supra* note 1413, at 275, 41; *Beach*, *supra* note 153, at 314; Abdulaziz Al-Dakhil*, Suq Al-Asehum Al-Soudi Quraa Tarikhia Wa Istishraf Lilmustaqbal* [The Saudi Stock Market Histroical Reading and Outlook for the Future], 115, (2010) (Ar).

[1415] *See* Awwad, *supra* note 1413, at 41.

[1416] The Saudi Companies Law [CL of 1965], Royal Decree No. (M/6), Dated 22/3/1385H (corresponding to July 22, 1965), *available at:* https://www.boe.gov.sa/ViewSystemDetails.aspx?lang=en&SystemID=373&VersionID=48. Saudi Arabian joint stock companies were regulated by the Saudi Arabian Companies Law of 1965 including the rules concerning securities initial public offerings and a few rules governing the secondary market. Moreover, the secondary market was governed by the ministerial committee, which was established by the Royal Decree No. (1230/8) dated 11/07/1403H (corresponding to April 24, 1983.) The supervision of the share trading and the exchange was under the authority of the Department of the Saudi Monetary Agency (SAMA). *See* Awwad, *supra* note 1413, at 41; *Beach, supra* note *153*, at 314.

[1417] *See Al-Ghamdi*, *supra* note 180, at 308.

[1418] CL of 1965, *supra* note 1416, art. 72.

insider trading.[1419] Commentators have noted that during the 1980s and early 1990s, the Saudi Arabian government was not concerned about combating abusive market conduct including illegal corporate insider trading where the market was thin and was traded by only a few investors.[1420] A Saudi Arabian governmental official in the mid-1990s asserted that: "The policy of the government, at the establishment of the Saudi market, was rather to encourage as much trading as possible and only later to introduce, step-by-step, more rules to the market."[1421] In the mid-1990s, the Saudi Arabian government attempted to develop the stock market by improving the regulations and the operations of the market.[1422] Among other regulatory improvements, the Ministerial Committee, which was the highest regularity power over the Saudi Arabian stock market, issued the Disclosure Rules of 1997.[1423]

Enacting the Disclosure Rules was an important step toward the development of regulating the illegal corporate insider trading ban. The rules required companies to make full disclosure of material developments, and contained provisions for prohibiting manipulation and trading on inside information.[1424] Dr. Awwad Saleh Awwad indicated that prior to the enactment of the Disclosure Rules of 1997, the Saudi Arabian stock market lacked clear and robust disclosure rules, which allowed companies and large investors to spread untrue statements and mislead investors about the true condition of listed companies and their financial earnings. Enacting the Disclosure Rules represented a coordinated effort

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[1419] *See* Awwad, at 275 Nt. 123.
[1420] Awwad, at 275; Mahayni, *supra* note 160, at 50.
[1421] *Id*. (Citing an interview with Mr. Mansoor Al-Mayman, Deputy Minister of Finance and National Economy, member of the Supervisory Committee, Riyadh, Nov 21, 1997.)
[1422] *See* Awwad, *supra* note 1413, at 275; Mahayni, *supra* note 160, at 52.
[1423] Awwad, at 410. Citing Ministerial Committee Disclosure Rules, Minster of Commerce Circular Reference Number 2222/221/9/3340 Date 8/11/1417.
[1424] Awwad, at 410.

to gain investors' confidence through the application of widely accepted disclosure regulations and to meet public demands for a strong disclosure regime that would ensure that public investors were given timely and accurate information.[1425] With regard to prohibiting illegal corporate insider trading, Article (4) of the Disclosure Rules described a general prohibition of trading on inside information. Article (4) reads: "Any person should not deal on inside information, information which is not published and freely available to the public, whether this information is received either indirectly or directly."[1426]

However, the Disclosure Rules of 1997 was criticized as it overly imposed technical and restrictive requirements along with broad prohibitions in the absence of an enforcement agency committed to applying and enforcing such regulations by supervising public disclosure and combating securities fraud and illegal corporate insider trading.[1427] In addition, the Disclosure Rules expressly lacked associated criminal sanctions or even civil liabilities.[1428] Article (4) was also criticized for its generality and the lack of clarity of its language.[1429] Dr. Awwad noted that as of 2000, no enforcement actions had been taken

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[1425] Awwad, at 95.
[1426] Disclosure Rules of 1997, *supra* note 1423, art. 4.
[1427] *See* Awwad, *supra* note 1413, at 254. *See* Mahayni, *supra* note 160, at 51; *Beach, supra* note *153*, at 317. (Joseph W. Beach contends that the previous regulations governing the Saudi Arabian stock market were enforced arbitrarily. He argues that "[T]he shifting sands of Saudi day-to-day governance did not provide an idea foundation for a stable capital market." *Id*. at 318.
[1428] Article (5) of the Disclosure Rules stated that: "The creation of an unfair market and/or persons acting on inside information, information which is not freely available to the public, is prohibited. Any violation will be punishable according to the regulation within the Kingdom." Awwad, *supra* note 1413, at 412. *See*, *id*. 253.
[1429] Mahayni, *supra* note 160, at 52; *Awwad*, at 334. (Dr. Awwad noted that Article 4 failed to define who is an insider, and thus ignored the distinction between companies' insiders and outsiders and the potential liability that could be imposed on them taking into consideration the degree of culpability and the knowledge about the wrongful conduct. *Id*. at 287 Dr. Awwad suggested that this would reduce the ability to enforce the Article. *Id*. at 334. In addition, Dr. Awwad criticized the broad definition of inside information in Article (4). It failed to distinguish between material publicly released information that would have an effect on the lack of related security and information. *Id*. at 279.

against insiders for trading on inside information, although a few warnings had been issued to some insiders for such illegal practices.[1430]

b. After Enacting the Capital Market Law

The turning point for the ban on illegal corporate insider trading occurred in 2003 when the ban was introduced under Article (50) of the CML.[1431] The CML imposes criminal punishment including a prison term of up to 5 years, and severe civil penalties for illegal corporate insider trading violations.[1432] Since the previous prohibition of illegal corporate insider trading under the Disclosure Rules of 1997 was criticized for the absence of one independent agency responsible for enforcing the prohibition, the CML established the CMA with administrative autonomy and large rulemaking powers along with the authority to implement and enforce the CML including charging illegal corporate insider trading wrongdoers.[1433]

Since the first years of its establishment, the CMA has considered combating illegal corporate insider trading as a priority to protect investors from unfair practices and ensure the equality of dissemination of information among market participants.[1434] The CMA has robustly pursued illegal corporate insider trading violations through multiple means including adopting rigorous regulations to govern illegal corporate insider trading, seeking judicial enforcement of the prohibition, and raising the public awareness about the prohibition of illegal corporate insider trading and its negative impacts.

1430 *Awwad*, at 303.
1431 CML, *supra* note 152, art. 50.
1432 *See Id*. arts 57(c), and 59.
1433 *See* Awwad, *supra* note 1413, at 336; Al-Dakhil*, supra* note 1414, at 279; *Beach, supra* note *153*, at 311.
1434 The Capital Market Authority, Annual Report 2007, 16, https://cma.org.sa/en/Market/Reports/Documents/cma_2007_report.pdf.

In November 2004, the CMA promulgated the Market Conduct Regulations (MCR), which is mostly concerned about prohibiting manipulation, illegal corporate insider trading, and misstatements and misrepresentation.[1435] Under this regulation, the CMA used its rulemaking authority and promulgated three articles to provide greater certainty and clarity for the prohibition of illegal corporate insider trading laid out under Article (50) of the CML. In addition to issuing regulations, in 2007, the Saudi Stock Exchange (Tadawul), which is responsible for executing the trading of securities, issued a new electronic trading system that has allowed the CMA to monitor the trading transactions and detect any unusual trading practices including illegal corporate insider trading activities.[1436] In 2007, the CMA began to announce a number of cases filed against illegal corporate insider trading wrongdoers.[1437] CMA's statistics revealed that from 2007 to 2017, 97 illegal corporate insider trading cases were issued by the CMA Board, CRSD, and ACRSD.[1438] In total, 81 cases (over 75 percent of the all the cases) were issued during the last three years.[1439]

The CMA has also been vigorous in enforcing the prohibition and charging violators of corporate insider trading. On August 17, 2009, the CMA announced the first illegal corporate insider trading case where a company's insider was sentenced to prison

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[1435] *See* MCR, *supra* note 156, arts. 1 to 10. *See* Aljloud, *supra* note 1407, at 180.
[1436] *See* The Saudi Stock Exchange (Tadawul), Annual Statistical Report (2007) *available at* https://www.tadawul.com.sa/wps/wcm/connect/6f5e1ab1-d31d-42a3-8bdf-abab761fb61e/Annual_Report_2007_English.pdf?MOD=AJPERES&CONVERT_TO=url&CACHEID=ROOTWORKSPACE-6f5e1ab1-d31d-42a3-8bdf-abab761fb61e-lHLGRHE;Annual Report 2007, *supra* note 1434, at 8; Andrew Englan & Abeer Allam, *First Insider Trader Is Jailed in Saudi,* Financial Times (Aug 18, 2009), *https://www.ft.com/content/02905c38-8c17-11de-b14f-00144feabdc0*; MOHAMED A. RAMADY, *THE* SAUDI ARABIAN ECONOMY: POLICIES, ACHIEVEMENTS, AND CHALLENGES, 153 (2nd ed. 2010).
[1437] *See* Annual Report 2007, *supra* note 1434, at 70-71.
[1438] *See* Capital Market Authority, Annual Report 2017, 236-37, https://cma.org.sa/en/Market/Reports/Documents/cma_2017_report.pdf.
[1439] *Id.*

by the CRSD.[1440] The CMA announced that the Committee found the Chairman of *Bishah* Company guilty of committing illegal corporate insider trading while he was serving as the chairmen of the company in violation of Article (50)(a) of the CML and Article (6)(a) of the Market Conduct Regulation.[1441] The Committee sentenced the accused insider to a three-month prison sentence, imposed a monetary fine of SR100,000 ($26,666), banned him from trading shares in the market for five years, and obliged him to disgorge SR52,690 ($14,056) representing the realized gain he had made from his illegal corporate insider trading transactions.[1442]

Recently, the CMA also announced the decision of the ACRSD against the former chairman of the second largest telecommunication operator company in the Kingdom, Etihad Etisalat (Mobily), his trading relative, and two other violators for trading and tipping inside information.[1443] On November 3, 2014, an investigation initiated by the CMA found that the company was misleading its shareholders about its real financial condition in 2013 and 2014 when it suffered a loss of more than $300 million.[1444] The investigation uncovered illegal corporate insider trading transactions committed by the former chairman

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[1440] The Capital Market Authority, Announcement by the Capital Market Authority Regarding the Issuance of a Final Adjudication by the Committee for the Resolution of Securities Disputes to Convict a violator of the Capital Market Law and its Implementing Regulations, (August 18, 2009), https://cma.org.sa/Market/NEWS/Pages/CMA_N528.aspx.
[1441] *Id*.
[1442] *Id*.
[1443] The Capital Market Authority, An Announcement form the Capital Market Authority, Regarding the Decisions Issued By the Appeal Committee for the Resolution of Securities Disclosures Convicting Violators of the Capital Market Law and its Implementing Regulations [Mobily's Decision], (Feb 26, 2018), https://cma.org.sa/en/Market/NEWS/Pages/CMA_N_2367.aspx.
[1444] *See* Shujae Al-Buqami, Al-Qawayam Al-Malia li sharikat Mobily Al-Saudia Tuzhar 'arbaha.. wa tadhad Shayieat Al-khsayr [The Financial Statements of Mobily Company Show Profits and Refute Rumors "Losses,"] Asharq Al-Awsat, last visited on Dec 11, 2018, (Nov 4, 2014), https://bit.ly/2QRGFnm; Telecommunications Services, Reuters, Saudi Market regulator says suspects insider trading in Mobily shares, last visited on Dec 11, 2018 (March 2, 2015), http://www.reuters.com/article/mobily-stocks-regulator-idUSL5N0W421320150302.

of the board of directors, and his trading relative when they sold a high portion of their stockholdings in Mobily.[1445] A media report revealed that on February 26, 2015, the chairman of Mobily reduced his stockholdings in the company, that he owned directly and indirectly through his private investment firm, to 5.3 million shares compared to 14.8 million shares at the end of 2013.[1446] The ACRSD convicted the former chairman for tipping and the relative for trading on the inside information received from the former chairman regarding the stock of Mobily in violation of Article (50) of the CML and Article (5) and (6) of the MCR of 2004. They imposed a fine of SR100,000 ($26,666) on each violator and prohibited them from working in listed companies for three years. The ACRSD also obliged the former chairman business investment company to pay SR280,948,800 ($74,919,680) to CMA's account for the avoided losses on the investment portfolio. The third and fourth violators were found guilty of committing trading on the investment portfolio of the third violator, imposing a fine of SR200,000 ($53,333) on the third violator, and obliging him to disgorge SR30,493,325.75 ($8,131,553.5) to CMA's account for the avoided losses. The fourth violator was fined SR100,000 ($26,666) and prohibited along with the third violator from working in listed companies for three years.[1447]

[1445] The Capital Market Authority, CMA Announcement in Regard to the Assignment of a Specialized Team to Review Etihad Etisalat Co. (mobily)'s Finciial Statements, Conduct Site Visits, Obtain Documents and Hear Concerned Parties' Statement, (Feb 26, 2015), https://cma.org.sa/en/Market/NEWS/Pages/CMA_N_1676.aspx; The Capital Market Authority, CMA Announces the Referral of a Suspicion of Violations of Article (50) of the Capital Market Law and Article (5) and (6) of the Market Conduct Regulations to the Bureau of Investigation and Public Prosecution, (May 13, 2015), *https://cma.org.sa/en/Market/NEWS/Pages/CMA_N_1782.aspx*.

[1446] Abdulaziz Al-Soghier Yatkharaj Bi'akthar Min 9 Malayin Sahm Fi Sharikat "Mobily" Khilal Eam 2014 [The Chairman of Mobily, sold more than 9 million shares of Mobily in 2014, Argaam News, (Feb 26, 2015), http://gulf.argaam.com/article/articledetail/488834.

[1447] Mobily's Decision, *supra* note 1443.

In addition to the enforcement of the prohibition of illegal corporate insider trading by seeking the imposition of sanctions and penalties, the CMA has also worked on increasing public awareness about the prohibition of illegal corporate insider trading.[1448] For this purpose, the CMA issued prospectuses describing examples of when illegal corporate insider trading occurs and why it is prohibited.[1449] For example, one brochure illustrated the occurrence of illegal corporate insider trading and the purpose of the prohibition by giving an example of a director or an employee of a listed company who discovered that the company would make above-expected profits. Then the insider purchased more shares of the company before the disclosure of the earnings of the increased profits, or disclosed the information to another person that could misuse the information for trading purposes.[1450] The CMA commented that this conduct does not contribute to the fairness of the market because the insider is taking advantage of information that is not available to general public investors.[1451]

Theory Underlying the Prohibition of Illegal Corporate Insider Trading

[1448] *See Saudi CMA Warns: Insider Trading Is a criminal Offense, Arab News* (Nov 22, 2015), http://www.arabnews.com/economy/news/839471.

[1449] *See* the Capital Market Authority, CMA Supports Companies and Market Participants to Prevent Insider Trading Crime (April 9, 2016), https://cma.org.sa/en/MediaCenter/PR/Pages/insider_trading.aspx; Hayyat Alsuq Tuhadir: Altadawul Bina'an Ala Maelumat Dakhilia Mahdur Wa Tuad "Jarima Jenayiya,"[The Capital Market Authority Warns: Trading on Insider Information is Prohibited and It Is a "Criminal Offense"] Mubashir News, (Nov 22, 2015), https://bit.ly/2rzpokt.

[1450] The Capital Market Authority, *Insider Trading Handbook, 3, available at, https://cma.org.sa/en/Awareness/Publications/booklets/English.pdf.*

[1451] *Id.*

The general rationale underlying the prohibition of trading on inside information, in Saudi Arabia is that inside information must not be exploited for trading purposes until the information becomes available to all public investors.[1452] The justification is that trading on inside information is unfair, it harms the safety of the market and public investors' confidence, and contradicts the policy of transparency and equal access to information.[1453] Thus, anyone who obtains inside information must refrain from trading or disclosing the information to another until the information becomes public knowledge.[1454]

The explanation for the unfairness of trading on inside information is that an insider would trade on inside information that other investors would and could not know about.[1455] The ACRSD and CMA view this informational asymmetry of trading on inside information as generating unjust profits that harm the integrity and safety of the stock market. The ACRSD has often asserted that the purpose of the prohibition of illegal corporate insider trading is to protect investors and establish justice and equality in access to information.[1456] The CMA also has announced that trading on inside information is against the principle of justice to have equal access to information, so the CML has imposed and protected investors by prohibiting trading on inside information under Article (50).[1457]

[1452] *See* ACRSD, Decision No.973/ L.S/ 2015 of 1437 H, season of 13/2/1437H (Corresponding to Nov 25, 2015), P. 15, http://crsd.org.sa/Ar/Appeals/قرارات%20عام%201437%20الجزء%20الأول/الملف%20الأول/-973-37.pdf. *See* also *Beach, supra* note *153*, at 344; *Gouda*, *supra* note 161, at 154.
[1453] ACRSD, Decision No.974/ L.S/ 2015 of 1437 H, season of 17/2/1437 (corresponding to Nov 29, 2015), P. 17, *available at*: http://www.crsd.org.sa/en/AppealsCommittee/Decisions/Documents/974-37E.pdf.
[1454] Fahad M. Al-Nufi, *Al-Himaya Al-Jinayiya Li-Asuk Al-malia Al-Sauodi* [The Criminal Protection for the Saudi Capital Market], 150, (2006), https://bit.ly/2rzpokt.
[1455] *See* ACRSD, Decision No.973/ L.S/ 2015 of 1437 H, P.17-18; Awwad, *supra* note 1413, at 336.
[1456] ACRSD, Decision No.147/ L.S/ 2009 of 1430 H, Season of 28/6/1430 (corresponding to June 21, 2009), P. 22, http://crsd.org.sa/en/AppealsCommittee/Decisions/Documents/147-30E.pdf.
[1457] ACRSD, Decision No.146/ ل.س/ 2009 of 1430H, season of 27/6/1430 (corresponding to June 20, 2009), P.14, http://www.crsd.org.sa/en/AppealsCommittee/Decisions/Documents/146-30E.pdf.

Trading on inside information contradicts CML's policy of requiring continuous disclosure to ensure that material events and developments are disclosed as soon as they are discovered.[1458] The CML requires issuers to not disclose inside information to other persons without confidentiality obligations, and to maintain adequate procedures to prevent any undesirable leaks before disclosing the information in accordance with the law and through recognized channels.[1459] Misusing inside information by secretly trading on that information is a complete contradiction to the policy of transparency in securities transactions and equal access to information.[1460] Moreover, one of the main functions that CML requires the CMA to pursue is to protect investors from unfair practices that involve fraud, manipulation, and cheating,[1461] including illegal corporate insider trading.[1462] The CML treats the prohibition of illegal corporate insider trading and the prohibition of manipulative practices under Chapter Eight of the law.[1463] The CML also provides severe imprisonment terms up to five years for both violations.[1464] This implies that the CML considers trading on inside information as harmful to the investor's confidence as manipulation. Therefore, the measures taken to deter such behaviors are the same.

[1458] CML, *supra* note 152, art. 46(a). (This Article requires an issuer to disclose to the CMA once such issuer becomes "aware of any material developments which may affect the prices of the Securities issued by such party. If such party has a Security traded on the Exchange, the Exchange must be informed of such developments in writing." *Id*.

[1459] *See* CML, *supra* note 152, art. (45)(c). (This Article considers information related to the annual and quarterly reports of the issuer related to the (1) balance sheet; (2) the profit and loss account; (3) the cash flow statement; and (4) "an evaluation of the issuing company management of current and future developments and any future possibilities that may have significant effect on the business results or financial position of the company" as confidential information before this information is disclosed to the CMA. It requires the issuer to prevent any "disclosing of such information to parties not bound by a confidentiality obligation and obligation to protect such information."

[1460] ACRSD, Decision No.974/ L.S/ 2015 of 1437 H, *supra* note 1453, P. 6.

[1461] *See* CML, *supra* note 152, art. (5)(a)(4). *See* also *Beach, supra* note *153*, at 325.

[1462] *See* Annual Report 2007, *supra* note 1434, at 16. (The CMA added illegal insider trading when enumerated the functions of CMA as spelled out under the CML.) *Id*.

[1463] CML, art. 49. *See* Aljloud, *supra* note 1407.

[1464] *See* CML, *supra* note 152, art. 57(c).

In addition, illegal corporate insider trading is principally prohibited for the purpose of preventing traditional insiders, such as directors and managers, from pursing self-interest and being selfish by trading on inside information or disclosing it selectively to their family members or business partners while the public is unfairly unaware of such information. In 2015. The CMA stated this justification:

> Trading based on inside information has direct negative effect on the Capital Market as well as investors therein. The efficiency of the performance of capital markets is associated with the confidence of investors. Such confidence has many bases, the first of which is guaranteeing that all investors would obtain all available information in an equal manner. They must be also provided with security and protection against illegal exploitation of inside information, which is not available to the public and only available to insiders by the virtue of their occupations and professions or disclosing such information to close persons or relatives. In order to level the playing field between investors in relation to the obtainment of information and prevent any person/s from utilizing inside information, legislations set texts criminalizing the illegal usage of inside information whether by insiders themselves or through others. This also aims to deter violators, achieve the security and integrity of free trading in the Exchange and to protect investors from prejudicing to equity between them.[1465]

On the basis of equal access to information, the prohibition range of trading on inside information is broad under the CML and its Implementing Regulations to include all possible scenarios when inside information could be exploited. The status of "an insider" has been broadened to include not only traditional company insiders, although inside information is more vulnerable to misuse by them, but also includes any persons who obtain inside information based on employment, contractual, or familial relationships.[1466] Thus, the prohibition of trading on inside information covers trading by outsiders who obtain inside information from insiders or from a chain of persons

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[1465] ACRSD, Decision No.973/ L.S/ 2015 of 1437 H, *supra* note 1452, P. 17.
[1466] CML, *supra* note 152, art. 50(a).

transferring inside information.[1467] The issue of who is subject to the prohibition of illegal corporate insider trading is discussed below.

<u>Who is Subject to the Prohibition of Illegal Corporate Insider Trading?</u>

Since the concept of the prohibition of trading on inside information is to protect the equal flow of information to the public domain, the CML and MCR have determined who is prohibited from misusing inside information for trading purposes, in both general and broad terms, to prevent all possible persons who have obtained inside information from trading on such information.[1468] However, the CML and MCR divide persons subject to the prohibition of trading on inside information into two categories. The first category includes those whom the regulations consider to be "insiders" presuming that they are aware of or have access to inside information, whether directly or indirectly. The other category includes all other persons (outsiders) who are not included in the first group.

Article (50)(a) of the CML defines an insider: "Any person who obtains, through family, business or contractual relationship, inside information (hereinafter an 'insider.')"[1469] The term insider has also been defined in more detail by the CMA under Article (4)(b) of the MCR, which reads as follows:

> (b) For greater certainty, insider means any of the following:1) A director, a senior executive or an employee of the issuer of a security related to inside information; 2) A person who obtains inside information through a family relationship, including from any person related to the person who obtains the information; 3) A person who obtains inside information through a business relationship, including obtaining the information: • From the issuer of a security related to inside information; • From any person who has a business relationship with the person who obtains the information; or • From any person who is a business associate of the person who obtains the information; 4) A person who obtains inside information through a contractual relationship, including obtaining the information: • From the issuer of a security related to inside information; or •From any person who has a contractual relationship with the person who obtains the information.[1470]

[1467] *Id*, art. 50(b).
[1468] Al-Nufi, *supra* note 1454, at 158.
[1469] *Id*.
[1470] MCR, *supra* note 156, art. 4(b).

The definition of an insider under Article (50)(a) of the CML and Article 4(b) of the MCR indicates that insiders exclusively are either company insiders including directors and managers, or outsiders who legally receive inside information directly or indirectly from the issuer because of family, business, or contractual relationships.[1471] The concept that correlates these types of persons as insiders is that the regulations do not consider their obtaining of inside information unlawful because their access to such information is for legitimate business purposes or any other purposes that are not related to the subject of the prohibition of illegal corporate insider trading. The goal, however, is to prevent the misuse of inside information for trading purposes. In addition, for the goal of protecting investors from such misuse of inside information, the regulations consider these persons to be under a duty to keep and maintain the confidentiality of the information. The regulations predicate that those persons have knowledge of inside information; thus, they have an insider status and are bound to a duty to maintain confidentiality of the information until such information becomes known to the public.[1472]

It is worth mentioning that the statutory definition of an insider does not require that such covered persons owe the issuer or the shareholders a fiduciary/trustee duty while obtaining inside information.[1473] This means that a violation of the prohibition of trading or disclosing inside information for trading motivations is not solely contingent on a breach

[1471] *See Gouda*, *supra* note 161, at 154.
[1472] *See* ACRSD, Decision No.973/ L.S/ 2015 of 1437 H, *supra* note 1452, P. 14.
[1473] *See Gouda*, *supra* note 161, at 155.

of such duty although a breach can simultaneously occur with the perpetration of this violation.[1474]

Article 50(b) of the CML and Article 6(b) of the MCR prohibit outsiders from trading on inside information where Article 50(b) states that: "(b) No person may purchase or sell a Security based on information obtained from an insider while knowing that such person, by disclosing such insider information related to the Security, has violated paragraph (a) of this Article."[1475] In addition, Article 6(b) of the MCR reads: "A person who is not insider is prohibited from engaging in insider trading if he obtains the inside information from another person and he knows or should have known, that the information is inside information."[1476]

The regulations prohibit outsiders from trading on inside information obtained from insiders while knowing that such disclosure is in violation of Article (50)(a) of the CML

[1474] Finding a simultaneous breach of fiduciary/trustee duty and illegal insider trading is obvious in the scenario of disclosure of inside information by a company's director to an outsider. When a company's director obtains inside information because of his/her privy position inside the company, and then disclosing such information to facilitate another person's trades, he/she commits illegal corporate insider trading and also a breach of his/her trustee/fiduciary duty owed to the company and shareholders not to misuse the property (information) of the company for self-interest and not to unfairly favor him/herself over the interest of the company and its shareholders. For more discussion about the breach of fiduciary duty by traditional company insiders, *see* Part 1 of Chapter 3: The Legal Status of Corporate Insiders. Some commentators have argued that since Article (50)(a) does not require an insider to be a fiduciary, the term "an insider" is not limited to persons obtaining inside information through family, business, or contractual relationships, but goes beyond that to include everyone in possession of inside information. *See Gouda*, *supra* note 161, at 155. This suggestion is based on the reading of the phrase "any person" at the opening of the definition of "an insider." *Id*. However, many commentators correctly conclude that the definition of "an insider" under Article (50)(a) of the CML and Article (4)(b) of the MCR is an express inclusive definition of "an insider." *See* Al-Nufi, *supra* note 1454, at 158; Mazhar Farghaly, Jari'yim Al-Tadawul Bina'an Alaa Maloumat Dakhilia [The Offences of Trading Based on Inside Information], 21, (April 2014) (unpublished manuscript) (on file with the student). Although the definition starts with a broad word "any person," it limits the scope of the term by using the word "because of" or "through family, business or contractual relationship." In addition, Article (4)(b) states in plain words that "for greater certainty, insider means any of the following…" which means clearly that any person that is not one of the enumerated persons is not "an insider" even though it is possible that such person becomes in possession of inside information.

[1475] CML, *supra* note 152, art. 50(b). *See Gouda, supra* note *161*, at 155; Beach, *supra* note *153*, at 344.

[1476] MCR, *supra* note 156, art. 6(b).

and Article (5)(a) and (b) of the MCR.[1477] The disclosure is in violation of paragraph (a) of this article, and occurs when the disclosure by the insider has not been made for legitimate purposes, but the insider discloses the inside information while he/she knows or has reason to know that the recipient of the information will trade on such information. Article 6(b) of the MCR also covers outsiders who obtain inside information although indirectly from an insider, if they know or should have known that the inside information is nonpublic, and it is material.

Who has Insider Status?

The determination of an insider under Article 50(a) of the CML and Article 4(b) of the MCR contains one of the requisites or elements that must be found to hold someone liable as an insider for trading on inside information that is unknown to the public. This element is called the "assumed element" upon which a defendant of illegal corporate insider trading shall have a special position or status of an insider, and thus be deemed liable where the other elements of the violation suffice. Thus, insiders can be divided into two groups: primary and secondary insiders.

Primary Insiders

With respect to misusing inside information for trading purposes, the main target group of the regulations is those who control and manage the issuer or represent the issuer in front of third parties.[1478] This includes all traditional companies' insiders, directors, senior executives, and other employees of the issuer, no matter what their position title is,

[1477] *Id*. art 5(a) and (b).
[1478] *See* Al-Nufi, *supra* note 1454, at 158; Farghaly, *supra* note 1474, at 21; Jamal Al-Othman, Al'iifsah wa Ashafafia fi Al-Maloumat Almutailiqa bi Al-Arwaq Al-Malia Al-Mutadawala fi Al-Bursa [The Disclosure and Transparency of Information Relating to Securities Traded on the Exchange], 350 (2010). (Ar.)

who are regularly privy to inside information.[1479] These insiders are the only expressly enumerated persons based on their positions under the definition of "an insider" in Article (4)(b) of the MCR. This implies that these insiders are the main target of the prohibition of trading on inside information and, in most instances, if others trade on inside information, these insiders would be the source of the information.[1480] It is notable that Article (4)(b) does not expressly name substantial shareholders as one of the issuer's insiders. However, many commentators suggest that substantial shareholders are included in this group of primary insiders.[1481]

The fulfillment of the presumed element of illegal corporate insider trading liability with respect to primary insiders is based on the notion that primary insiders, by virtue of their special positions inside the company, are always informed about the company's affairs and any new developments during the course of the business operation.[1482] The CMA has considered this presumed element as irrefutable because primary insiders' access to inside information by virtue of their privy positions prevents them from alleging that their trading in the issuer's stock preceding the announcement of material information occurred while they had no access to such information.[1483]

In a case before the ACRSD,[1484] the CMA asserted that Article (50)(a) necessitates a presumed element to impute liability for illegal corporate insider trading for those who

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[1479] *See Id*.
[1480] Awwad, *supra* note 1413, at 285.
[1481] *See* Farghaly, *supra* note 1474, at 24. *See* also *Id*.
[1482] Ahed Al-Saeed, Dealing with Confidential Information of Public Share Holding Companies – Comparative Study, 285, (2012), https://meu.edu.jo/libraryTheses/58b2b6b5c5bbf_1.pdf. (Ar.).
[1483] *See* ACRSD, Decision No.147/ L.S/ 2009 of 1430 H, *supra* note 1456, P. 12.
[1484] *Id*. (The facts of the case involve a company's director who traded in the shares of his company based on inside information indicating that the board of directors will discuss the possibility of transferring its affiliate companies to be one public joint stock company or merging these affiliate companies to its company and the likelihood of the capital increase accordingly. The insider traded, as an agent, through an investment account

occupy a special legal status of an insider. It is always presumed that their trades are based on inside information obtained because of their inside position at the time of the trade in question where other elements of the offense suffice.[1485] In this case, the CMA stated that the defendant held the position of Vice Chairman of the Board of Directors of the company when he purchased the company's stock. Therefore, the presumed element was definitely proven that he had access to inside information.[1486] In addition, the ACRSD explained that the presumed element under Article (50)(a) requires the presence of two elements: (1) the defendant is "an insider" who obtains inside information because of his/her position; and (2) the inside information in question satisfies the legal requirements in which the information is unknown to the public, and its availability to the public would substantiality impact the price of the related security. The ACRSD concluded that the presumed element was satisfied for the defendant since the defendant was Vice Chairman of the Board of Directors. The obtained information was that the defendant along with other directors requested a feasibility study about converting a number of affiliates, in which the company had invested in, into a public joint stock company or integrate them with their company and thus increase the company's capital.[1487] The ACRSD found that the presumed element under Article (50)(a) sufficed because the defendant was an insider and the request to conduct the study was inside information.[1488]

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of his six family members during the period that directly preceded the company's board of directors meeting to decide to launch the study and before the announcement about its decision to conduct a study on the feasibility of converting a number of its affiliates to be joined in one public joint stock company or merging them to the parent company in which it would lead to a capital increase of the company, accordingly.) *Id*. P.1.

[1485] *Id*. P. 12.

[1486] *Id*.

[1487] *Id*. P. 20.

[1488] *Id*.

Secondary Insiders

Secondary insiders include all other enumerated persons who are deemed to have the legal status of an insider under Article (50)(a) of the CML and Article 4(b) of the MCR. These individuals include those who legally obtain inside information either directly from the issuer and persons acting on its behalf, or indirectly from others who originally obtain the inside information from the issuer or one of its insiders.[1489] These persons are enumerated in inclusive terms as any person who obtains inside information through a family, business, or contractual relationship.[1490] This group includes private contractors who have a temporary business relationship with the issuer that gives them access to inside information for business purposes, such as private lawyers, external auditors, and financial advisors.[1491] Secondary insiders also include low-level employees of the issuer who do not have regular access to inside information.[1492] In addition, family members of primary insiders or other insiders are also considered secondary insiders who are subject to the prohibition of trading on inside information obtained from a family source.

Article (4)(b) describes when such company outsiders are legally deemed to occupy the status of an insider: A person is deemed "an insider" if such person obtains inside information through:

(1) A direct business relationship with the issuer of the related security, or indirectly through a business relationship with another person, or from a business associate of the person who obtains the information;

1489 *See* Farghaly*, supra* note *1474*, at 24; Ahmad Baz Metwally, *Al'ikhlail al-Juzyie bi Al-Iltizaim bi Al-Shafafia wa al-Ifsah aun Al-Maloumat fi Bursa Al-Arwaq Al-Malia- Al-Tayamul Al-Dakhiliyah* [The Partial Breach of Duty of Disclosure and Transparency of Information on the Stock Exchange- Insider Dealing], 28 (2012). (Ar.).
1490 CML, *supra* note 152, art. 50(a).
1491 *See* Farghaly*, supra* note *1474*, at 25; Metwally, *supra* note 1489, at 28.
1492 *Id*.

(2) A direct contractual relationship with the issuer of the related security, or indirectly obtained the information from any person who has a contractual relationship with the person who obtains the information; and

(3) A family relationship, including any person related to the person who obtains the information (who is deemed to occupy the legal status of an insider).[1493]

Article (4)(b) indicates that persons have insider status if they legally obtain inside information because of a direct business or contractual relationship with the issuer or one of the primary insiders, or indirectly from a source with whom he/she has a business or contractual relationship. It also includes any person who obtains inside information through a family relationship with one of the primary insiders or other secondary insiders. This means that the prohibition of trading on inside information covers first-level persons informed about inside information as well as other persons who obtain the information through a chain of persons who are privy to inside information.[1494] Although the definition of an insider under Article (50)(a) of the CML and Article (4)(b) of the MCR is a broad definition, some commentators argue that this legal definition does not include all possible persons that may obtain inside information.[1495] For example, a person could obtain inside information through a friendship relationship. However, the definition focuses on specific relationships from which inside information is most likely to be obtained either from the

[1493] MCR, *supra* note 156, art. 4(b).
[1494] *Gouda, supra* note *161*, at 156.
[1495] Al-Nufi, *supra* note 1454, at 158.

issuer or indirectly from sources that have legally obtained the inside information through a business or contractual relationship.[1496]

The CMA believes that all secondary insiders are always presumed to have access to inside information if other elements of the violation suffice. Therefore, the assumed element required pursuant to Article (50)(a) of the CML is satisfied.[1497] However, some commentators correctly suggested that the assumed element does not suffice regarding secondary insiders in the absence of evidence showing that the inside information is related to the matter of their job duties or a responsibility they were contracted to perform.[1498] For example, for a low-level employee who works in the accounting department of a listed company, it is reasonable to presume that he/she is informed about inside information related to confidential financial information of the listed company. However, for a low-level employee who works as a receptionist at a listed company, the presumption that this employee is an insider is based on conjecture and should not suffice the assumed element unless there is additional evidence connecting the employee to the inside information.[1499]

With regard to persons obtaining inside information through a family relationship, the CMA illustrates the justification of adopting the presumption that family members occupy the legal status of an insider by stating that:

> The CMA regards the transfer of inside information between family members is presumed as circumstantial evidence where it is confirmed to be a fact when the information is used by such family members through trading in the security in question. This presumption of the transfer of inside information between family members has been adopted by many legislations, which tend to include spouses and relatives under the prohibition of illegal

[1496] *See Gouda, supra* note *161*, at 155 Nt. 152. (The authors conclude that family, business, and contractual relationships "are meaningful in the Saudi community. In all likelihood, if insider trading were to take place, it would be through these relations.") *Id*.
[1497] *See* ACRSD, Decision No.147/ L.S/ 2009 of 1430 H, *supra* note 1456, P. 12.
[1498] Farghaly*, supra* note *1474*, at 24; Metwally, *supra* note 1489, at 28.
[1499] This suggestion is derived from Professor Donald Langevoort's analysis. *See LANGEVOORT, supra* note *6, at* §3:13.

> corporate insider trading as the same as original insiders. This inclusion is established because of two reasons: (1) the impossibility of proving that the disclosure to a spouse and relatives by the regular methods of evidence because of the close relationship between them; and (2) because of the nature of human selves, the disclosure of inside information can possibly occur intentionally or unintentionally between very close persons while mutual dialogues.[1500]

Although CMA stresses that trading relatives are always presumed to be privy to inside information, in 2009, the ACRSD asserted that the family relationship connection does not by itself demonstrate that a defendant has obtained inside information unless this presumption is supported by other evidence.[1501] This case involved an allegation that a chairman of a listed company (first defendant) and his brother (second defendant) purchased shares of the chairman's company before the announcement of an acquisition deal.[1502] The allegation regarding the satisfaction of the presumed element with respect to the second defendant was based on the fact that the chairman's brother was a statutory insider who was presumed to have access to inside information obtained from his brother (the chairman). Therefore, the CMA presumed that since the information was available to the chairman of the company, the chairman disclosed the information to his brother.[1503] To confirm this presumption, the CMA stated that the trading activities of the chairman's brother on the related stock showed that he was trading on low volume in the past, but he suspiciously traded on a large volume in the period preceding the disclosure about the acquisition deal.[1504] However, the attorney of the chairman's brother successfully rebutted this presumption by producing other evidence, thus weakening the presumption of

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[1500] ACRSD, Decision No.973/ L.S/ 2015 of 1437 H, *supra* note 1452, P. 14.
[1501] ACRSD, Decision No.148/ L.S/ 2009 of 1430 H, season of 30/6/1430 (corresponding to June 23, 2009), P. 22, http://crsd.org.sa/en/AppealsCommittee/Decisions/Documents/148-30E.pdf.
[1502] *Id*. P.1.
[1503] *Id*. P. 9.
[1504] *Id*. P. 10.

obtaining inside information.[1505] Although the ACRSD convicted the chairman of trading on inside information before the public disclosure of the acquisition deal, it acquitted the chairman from illegal corporate insider trading liability of unlawful disclosure to his brother.[1506] The ACRSD stated that it was not persuaded by the evidence produced by the CMA that the chairman's brother traded on inside information received from his brother.[1507] First, the ACRSD found that the family relationship between the defendants was not certain evidence to demonstrate the disclosure to the chairman's brother unless it was supported by other evidence. Second, the suspicious large volume trading in the company's stock preceding the disclosure of the acquisition deal was insufficient evidence to prove that the trading was based on inside information[1508] since there were other reasonable justifications of such high trading volume, which weakened the presumption. They reasoned that rumors circulated on the internet about a rise in the company's capital, which led to an increased market price of the company's stock before the disclosure of the acquisition deal. In addition, the chairman's brother was a frequent trader in the company's stock.[1509]

In another case issued in 2015, the ACRSD concluded that there was enough evidence to convict trading relatives for illegal corporate insider trading. The facts of this case involved an allegation against two listed company's directors who were also brothers. Four of their family members traded on inside information related to a real estate sale of

[1505] *Id*. P. 6.
[1506] *Id*. P. 23.
[1507] *Id*. P. 22.
[1508] *Id*.
[1509] *Id*.

the company.[1510] The allegation indicated that the trading relatives purchased a high number of shares during the period between the signing of the sale agreement and the public disclosure of the deal based on inside information obtained from the first defendant. After the sale was announced, the defendants sold all their shares in the company.[1511] The ACRSD found that the presumption of the occurrence of the disclosure and the obtaining of inside information was sufficient to find liability of illegal disclosure and trading on inside information by the defendants.[1512] They reasoned that the first defendant was a member of the executive committee of the company and was authorized to sign and conclude the sale deal. Thus, the inside information, which was the sale of the real estate, was definitely available to the first defendant.[1513] Second, the Department of Surveillance and Analysis of CMA's report showed that the trading relatives purchased a large number of shares of the listed company in question before the announcement of the sale confirmation.[1514] In addition, the timing of their trading was suspicious because it occurred after receiving an offer that was described as a serious offer and after the consent of the other partner sharing ownership of the real estate with the company.[1515] Third, the trading relatives provided contradictory justifications for their trading activities. Finally, there was no trading activity by the trading relatives during the previous six months before the public disclosure.[1516]

[1510] ACRSD, Decision No.973/ L.S/ 2015 of 1437 H, *supra* note 1452, P. 1.
[1511] *Id*. P. 3.
[1512] *Id*. P. 20.
[1513] *Id*.
[1514] *Id*.
[1515] *Id*. P. 21.
[1516] *Id*.

In summary, it can be suggested that the presumption of trading on inside information obtained through family relationships can be rebutted by showing that there were other reasons for the trade, such as circulated rumors that caused the market price of the stock to rise, or the person has a history of trading in the stock in question.[1517] However, the presumption can be confirmed in the absence of a justified explanation of the trade decision.[1518] In particular, when a suspicious trade is conducted by one or more members of the same family, or the family member has no trading history in the previous six months of the public disclosure, the trading activity can be called into question.[1519]

Liability of Outsiders Trading on Inside Information

In addition to the prohibition of trading on inside information, the Saudi Arabian regulations prohibit insiders from disclosing inside information to others for the same reason that prohibits them from trading by themselves.[1520] The regulations go further to prohibit recipient outsiders from trading on or communicating inside information either obtained directly from an insider or indirectly through a chain of recipients of such information.[1521] This prohibition is imposed to close any legal loopholes by which inside information may be exploited for trading purposes and to ensure confidentiality of the information until it is disclosed to the general public.[1522]

[1517] ACRSD, Decision No.148/ L.S/ 2009 of 1430 H, *supra* note 1501.
[1518] ACRSD, Decision No.973/ L.S/ 2015 of 1437 H, *supra* note 1452.
[1519] It is important to mention that there is no specific definition of family members subject to the status of "an insider" under Article (50)(a) of the CML. Dr. Mazhar Farghaly suggests that the definition should be determined narrowly because the violation of trading on inside information is a criminal offense. He also suggests that the definition applied herein is the same as the definition of family members associated or related to directors and senior executives or substantial shareholders defined in the Glossary of Defined Terms issued by the CMA, which include only the "individual's spouse or minor children." Glossary of Defined Terms, *supra* note 1393. *See* Email from Dr. Mazhar Farghaly to the student (Jan 8, 2019, 1:14 PM) (on file with the student).
[1520] Metwally, *supra* note 1489, at 35; Al-Othman*, supra* note 1478, at 358.
[1521] CML, *supra* note 152, art. 50(b); MCR, *supra* note 156, art. 5(b), and (6)(b).
[1522] *See* Metwally, at 35.

Prohibition of Disclosing Inside Information to Outsiders

Article (50)(a) of the CML prohibits insiders from disclosing inside information "to another person with the expectation that such person will trade in such information." In addition, Article (5)(a) of the MCR provides that: "An insider is prohibited from disclosing any inside information to any other person when he knows or should have known that it is possible that such other person may trade in the security related to the inside information."[1523] Article (5)(b) goes on to prohibit outsiders from disclosing inside information obtained from insiders. It states that: "A person who is not insider is prohibited from disclosing to any other person any inside information obtained from an insider, when he knows or should have known that it is possible that such other person to whom the disclosure has been made may trade in the security related to the inside information."[1524]

On the basis of these articles, the prohibition of disclosing inside information to outsiders does not require the fulfillment of the assumed element, which means that it is not necessary for the information to be disclosed by an insider.[1525] The elements required to establish liability for disclosing inside information under Article (50)(a) of the CML and Article (5) of the MCR are as follows: (1) the information disclosed meets the legal attributes of inside information under Article (50)(a) of the CML and Article 4 (c) of the MCR; and (2) the disclosure was committed with the expectation that such recipient will trade on the information received. Or, as Article (5) states, the disclosing person "knows or should have known that it is possible that such other person may trade in the security

[1523] MCR, *supra* note 156, art. 5(a).
[1524] *Id*. art. 5(b).
[1525] *See* Al-Nufi, *supra* note 1454, at 178; Farghaly*, supra* note *1474*, 42,45.

related to the inside information."[1526] Any disclosure that meets these two elements is prohibited and the person making such a disclosure is punished the same as if he/she had traded on inside information.[1527]

The general understanding of this prohibition is that insiders who are privy to inside information and outsiders who obtain such information from insiders have a duty not to disclose inside information to outsiders until the information is disclosed to the general public.[1528] Therefore, a violation of the prohibition from disclosing inside information articulated under these provisions does not apply when the disclosure was made for legitimate legal purposes such as passing inside information between directors of the board of the issuer or disclosing it to a private lawyer representing the issuer in a legal matter.[1529] The scope of this prohibition applies when the disclosure is made to outsiders for illegitimate purposes in which the insider violates his/her duty under Article (50)(a) of the CML and Article (5) of MCR .

<u>Does Disclosure have to be Related to Trading on Inside Information or is Mere Disclosure Prohibited Conduct?</u>

The CMA interprets that the prohibition from disclosure under Article (50)(a) of the CML and Article (5) of the MCR applies whenever the disclosure is made for non-business purposes (i.e., the disclosure is made to a person not bound by a confidentiality obligation).[1530] This disclosure contradicts the protection that the CML has provided to

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1526 MCR, *supra* note, 7, art. 5(a) and (b). *See* ACRSD, Decision No.973/ L.S/ 2015 of 1437 H, *supra* note 1452, P. 20; ACRSD, Decision No.424/ L.S/ 2012 of 1433 H, season of 20/2/1433 (corresponding to Jan 14, 2012), P. 2, http://www.crsd.org.sa/en/AppealsCommittee/Decisions/Documents/424-33E.pdf.
1527 *See* Farghaly, *supra* note *1474*, 45.
1528 *See* Decision No.973/ L.S/ 2015 of 1437 H, *supra* note 1425, P. 15; Farghaly, *supra* note *1474*, at 41; Metwally, *supra* note 1489, at 35.
1529 *See* Farghaly, *supra* note *1474*, at 42.
1530 *See* ACRSD, Decision No.424/ L.S/ 2012 of 1433 H, *supra* note 1526, P. 3; Farghaly, *supra* note *1474*, at 42; Al-Nufi, *supra* note 1454, at 160.

maintain confidentiality of the information before it flows to the general public to establish equal access to information.[1531] Therefore, the CMA finds that the mere breach of a duty to maintain confidentiality of inside information results in liability under Article (50) of the CML or Article (5) of the MCR. In addition, it is notable that by promulgating Article (5) of the MCR, the CMA has softened the element of the requisite state of mind of the disclosing person or has objectively presumed that it is sufficed.[1532] This presumption is in conflict with the plain language of Article (50)(a). It requires that for finding a violation of disclosing inside information by insiders, the disclosing insider must have actual knowledge or, at least, an expectation that the recipient of the inside information will trade on this information.[1533]

The issue of insiders' liability for unlawful disclosure was reviewed by the ACRSD, in 2012.[1534] This case involved an appeal by the CMA against the CRSD's decision that reversed the Board of the CMA's decision to financially fine an executive insider for making a press statement containing inside information to a news organization. The Board of CMA fined the executive insider SR50,000 ($13,333) for violating Article (5)(a) of the MCR. The argument was that the insider made a press statement to Reuters before notifying the CMA about the insider's company expectation of increasing the net profit for the first quarter of 2009 at least 200% over the previous quarter.[1535] The executive insider filed a

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[1531] *See* ACRSD, Decision No.973/ L.S/ 2015 of 1437 H, *supra* note 1452, P. 15.
[1532] Al-Nufi, *supra* note 1454, at 182.
[1533] CML, *supra* note 152, art. 50(a) (This Article states that: "Any person who obtains, through family, business or contractual relationship, inside information (hereinafter an "insider") is prohibited… to disclose such information to another person with the expectation that such person will trade in such Security.") *Id*.
[1534] ACRSD, Decision No.424/ L.S/ 2012 of 1433 H, *supra* note 1526.
[1535] *Id*. at P. 2.

grievance against the decision before the CRSD and it rendered a judgment in favor of the insider and canceled the CMA Board's decision. Subsequently, the CMA appealed.[1536]

The CMA claimed that it imposed a financial penalty against the insider because he had a privy position, he knew or should have known the nature of the confidentiality of the information and the legal means to disclose. The CMA argued that the decision was imposed because the goal was to protect and maintain confidentiality of inside information and thus, insiders were required to refrain from disclosing it to anyone not bound to keeping the information confidential.[1537] The CMA claimed that the alleged violation committed by the insider satisfied the requisites and elements articulated under Article (5)(a) of the MCR, which included more details than Article (50)(a) of the CML.[1538] The CMA explained the elements required by Article (5)(a) as follows: (a) the disclosing person is an insider; (b) the disclosed information meets the legal attribute of inside information; (c) when making the disclosure, the insider knows or should know the information is inside information; and (g) the disclosure is made to an outsider.[1539] The CMA found that the executive was an insider, and the information disclosed was inside information that the insider knew or should have known was inside information, and the disclosure was made to an outsider. Therefore, "all the elements required by the provision of the article existed."[1540]

The ACRSD confirmed the CRSD's decision that the act committed from the insider did not violate Article (50)(a) of the CML when he disclosed inside information to

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[1536] *Id.*
[1537] *Id.*
[1538] *Id.*
[1539] *Id.*
[1540] *Id.*

a Reuters agent.[1541] While recognizing that the Board of CMA's decision was based on Article (5)(a) of the MCR, the CRSD read Article (50)(a) as it requires that an insider making the disclosure must have actual knowledge or an expectation that the person receiving inside information will trade based on this information.[1542] Thus, it concluded that this element was absent in the case, and Article (5)(a) of the MCR, upon which CMA based its decision, did not apply to the act the insider committed.[1543]

On the basis of this case, it can be noted that the CMA has intended to prohibit any breach of the duty of confidentiality by the issuer's insider by making such conduct actionable under Article 5(a) of the CML. However, based on the CMA's understanding, it can be argued that the language of Article (5) of the MCR prohibits conduct that is out of the scope of illegal corporate insider trading of which Article (50)(a) of the CML was designed to prohibit. The prohibition from disclosing inside information under Article 50(a) of the CML was to prevent insiders from selectively disclosing inside information to investors and thus giving them an unfair informational advantage over the market because of their illegal access to inside information.[1544] Therefore, Article (50)(a) triggered the prohibition from selectively disclosing inside information when there is an expectation that the recipient of the information will trade on that information. However, the CMA believes that the goal of Article (5) of the MCR is to maintain confidentiality of inside information

[1541] *Id*. at 4.
[1542] *Id*.
[1543] *Id*.
[1544] This notion has been used by the CMA in illegal insider trading proceedings to justify prohibiting insiders from selectively disclosing inside information to their relatives to trade. *See* ACRSD, Decision No.973/ L.S/ 2015 of 1437 H, *supra* note 1452, P. 17-18. (The CMA stated that legislators set texts criminalizing the illegal usage of inside information whether by insiders themselves or through others for the goal of achieving the safety and integrity of securities trading in the Exchange and to protect investors from depriving them the right to have equal access to information.) *Id*. at P.18.

disregarding whether the disclosing person is an insider or not and notwithstanding that the disclosing person would expect the recipient to trade, and whether or not the recipient actually misused the information.[1545] As a result, it can be argued that Article (5) of the MCR goes too far beyond the purpose of prohibiting illegal corporate insider trading. Therefore, in this case, the CRSD and ACRSD correctly rejected this broad approach and restricted the prohibited conduct of disclosing inside information to acts involving actual knowledge or at least the existence of circumnutates that reasonably lead to an expectation that the recipient of the inside information will trade or disclose the information to trade on this information.[1546] In fact, Article 50(b)'s prohibition of trading on inside information by outsiders supports this conclusion since it restricts liability to an outsider's knowledge of inside information that the insider expected the outsider to trade on.[1547]

<u>Outsiders' Prohibition from Trading on Obtained Inside Information</u>

Since the purpose of prohibiting illegal corporate insider trading is to prevent the exploitation of inside information to ensure that investors are trading on the same publicly available information, illegal corporate insider trading regulations prohibit outsiders who improperly obtain inside information from trading on such information or disclosing it to others for the same purpose. Article (50)(b) of the CML states that "no person may purchase or sell a security based on information obtained from an insider while knowing that such person, by disclosing such insider information related to the Security, has violated paragraph (a) of this Article."[1548] An insider violates paragraph (a) of Article (50) by disclosing inside information "to another person with the expectation that such person will

[1545] ACRSD, Decision No.424/ L.S/ 2012 of 1433 H, *supra* note 1526, P. 2.
[1546] *Id*. at 3.
[1547] CML, *supra* note 152, art. 50(b).
[1548] *Id*.

trade in such security." In addition, Article (6)(b) of the MCR states that: "A person who is not insider is prohibited from engaging in insider trading if he obtains the inside information from another person and he knows or should have known, that the information is inside information."[1549]

The elements required to find outsiders liable for trading on inside information are as follows: (1) An outsider trades on obtained inside information; and (2) such outsider has knowledge that the obtained information is inside information that he/she knows that he is in possession of and he/she deliberately intends to exploit the information before the public disclosure.[1550] However, the element of requiring that an outsider must have knowledge that the obtained information is received directly or indirectly from an insider is unclear.

Does an Outsider need to Know that the Inside Information was Obtained Directly or Indirectly from an Insider?

The language of Article (50)(b) of the CML apparently requires that the recipient outsider must know that the insider (by disclosing inside information) has expected that the outsider will trade on the information.[1551] Therefore, the apparent meaning of this language indicates that not every disclosure of inside information prohibits recipient outsiders from trading on such information. Outsiders are only prohibited from trading when they have positive knowledge that the disclosing person is an insider and the disclosure was with the expectation that the recipient will trade.[1552] Some commentators have noticed that Article (50)(b) uses the gerundive "while knowing" which "means the

[1549] MCR, *supra* note 156, art 6(b).
[1550] ACRSD, Decision No.974/ L.S/ 2015 of 1437 H, *supra* note 1453, P. 13.
[1551] CML, *supra* note 152, art. 50(b). (This Article states that: "No person may purchase or sell a security based on information obtained from an issuer while knowing that such person, by disclosing such insider information related to the security, has violated paragraph (a) of this Article.") *Id*.
[1552] *See Gouda*, *supra* note 161, at 156.

seller/buyer of the security must have a positive knowledge that the information he is using is leaked by an insider."[1553]

However, the CMA has interpreted Article (50)(b) in a different direction by promulgating Article (6)(b) of the MCR.[1554] This Article does not require that an outsider must receive inside information from an insider but generally states that the inside information is obtained from "another person."[1555] The CMA defines "another person" as "any natural or legal person recognized as such under the laws of the Kingdom."[1556] The CMA has asserted that the identity of the disclosing person is irrelevant to the elements of liability of outsiders trading on inside information.[1557] The only fact that an outsider needs to know or should know is that the information obtained is inside information meeting the legal attributes stated under Article (50)(a) of the CML and Article (4)(c) of the MCR.[1558] Therefore, it can be said that the CMA provides a general prohibition of any attempts to exploit inside information through promulgating Article (6)(b), in which inside information must not be subject to trading activities by any person whether the information originated from an insider or not and whether or not the recipient outsider knows the information was leaked by an insider.[1559] However, one commentator argued that the CMA, by promulgating Article (6)(b), has incorrectly presumed that the material element to prohibit outsiders from trading on inside information is the knowledge of the confidential nature of

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[1553] *Id*.
[1554] MCR, *supra* note 156, art. 6(b).
[1555] *Id*. (This Article states that: "A person who is not insider is prohibited from engaging in insider trading if he obtains inside information from another person and he knows or should have known, that the information is inside information.") *Id*.
[1556] Glossary of Defined Terms, *supra* note 1393.
[1557] ACRSD, Decision No.146/ 2009 /ل.س of 1430H, *supra* note 1457, at P. 8.
[1558] *Id*; ACRSD, Decision No.974/ L.S/ 2015 of 1437 H, *supra* note 1453, P. 5.
[1559] *Id*.

the received information and not the source of the information as Article (50)(b) expressly states.[1560] Thus, the commentator argued that the CMA has broadened the scope of an illegal corporate insider trading offense to include conduct that the legislators did not intend to prohibit under Article (50)(b).[1561]

The ACRSD has reviewed this issue on two occasions. In 2009, the ACRSD expressly rejected the CMA's argument and stated that Article 50(b) of CML stated clearly that a trading outsider must know that the information he/she possesses is obtained from an insider who violated Article 50(a) because of the disclosure.[1562] However, in 2015, the ACRSD concluded that evidence of trading patterns at suspicious times preceding major public disclosure, and the defendant's acknowledgment that he knew that the information he possessed was material and specific information, were enough evidence to find the defendant liable based on Article 6(b) of the MCR.[1563]

In 2009, the ACRSD reviewed a case brought by the CMA alleging that two outsiders traded on inside information in violation of Article (50) of the CML and Articles (5)(b) and 6(b) of the MCR.[1564] The facts of this case involved two defendants. On two separate occasions, the first defendant received inside information which he disclosed to his son-in-law (the second defendant) and they traded simultaneously on that information.[1565] The main dispute between the defendants' attorney and the CMA was a

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[1560] Al-Nufi, *supra* note 1454, at 186.
[1561] *Id*.
[1562] ACRSD, Decision No.146/ ل.س/ 2009, *supra* note 1457.
[1563] ACRSD, Decision No.974/ L.S/ 2015 of 1437 H, *supra* note 1453.
[1564] ACRSD, Decision No.146/ 2009 /ل.س of 1430H, *supra* note 1457.
[1565] *Id*., The facts of this case are as follows: The first time, on October 29, 2004, the first defendant instructed his broker to purchase a large number of shares of a company because he was informed that the Board of Directors of this company issued a letter to the Minister of the Ministry of Commerce regarding an increase in the company's capital. The first defendant told his broker that the increase in the company's capital would be announced shortly—within two days—and they were just waiting for the ratification by the Minister. The

question of law: whether the CMA is required to prove that the source of the information was an insider in accordance with the definition of an insider under Article (50)(a) of the CML and Article 4(b) of the MCR.[1566] The defendants' attorney claimed that to hold his clients liable for trading on inside information, the CMA must identify the person who disclosed the inside information to know whether he/she was an insider or not.[1567] If the source of the information was an outsider, then the elements of illegal corporate insider trading were not satisfied because the regulations require that the disclosure be made by an insider in violation of his/her duty under (50)(a).[1568] However, the CMA rebutted the attorney's argument by stating that the defendants' attorney wrongfully alleged that the name or identity of the source of the information was necessary to find the defendants liable of violating Article 50 of the CML and Article (5)(b) and (6)(b) of the MCR.[1569] The articles do not require, as an element of illegal corporate insider trading liability, that the source of the information is known. There are two elements of illegal corporate insider

first defendant also was sure that the rise after the public disclosure would be around SR40 ($10.6) to SR50 ($13.3). At the same time, the first defendant's son-in-law (second defendant) purchased a high number of the same company's shares. The CMA alleged that the second defendant based his trading in this company on the information disclosed by the first defendant. The evidence provided by CMA was recordings of telephone conversations between the first defendant and his broker, and the acknowledgment by the first defendant that the telephone conversations belonged to him. In addition, the defendants gave contradictory statements, and there was no trading history in this company during the previous six months. The evidence also indicated that the second defendant's purchase of shares coincided with the first defendant's purchase and the close relationship between them. For the second trading time, the CMA alleged that the defendants traded on inside information on December 18, 2004. The first defendant obtained inside information from an insider, then disclosed the information to the second defendant who sold all their stocks in the company. Based on the telephone conversation recordings between the first defendant and his broker, the first defendant said that "people expected the board of *** Company to announce something. But when I enquired, the board told me that nothing will be announced, thus I told you to sell the shares." The presented evidence was that the first defendant acknowledged that it was his voice on the recordings. On the same day, the second defendant sold all of his stocks in the company, in addition to the same evidence presented by the CMA regarding the first alleged violation. *Id*. at P. 1-4, 19.

[1566] *Id*. at P. 5.

[1567] *Id*.

[1568] *Id*. at P. 6.

[1569] *Id*. at P. 8.

trading liability required in the regulations: (1) trading by any person based on obtained inside information related to the traded security in question; and (2) with the requisite state of mind. In other words, a willful violation that is enough to establish liability and general criminal intent. This means that the violator knows that he has information that is inside information and he/she deliberately intended to exploit it by trading or attempting to trade.[1570]

The ACRSD rejected the CMA's argument and stated that Article (50)(b) expressly requires a special status of the source of information (i.e., an insider).[1571] This requirement is emphasized by requiring that the outsider must be aware that by disclosing the inside information, the insider has violated Article (50)(a).[1572] In regard to the first alleged violation, the ACRSD concluded that it could not infer from the available evidence that the first defendant received inside information from an insider. However, for the second alleged violation, the ACRSD found the defendants liable for trading on inside information because the source of the information proved to be an insider. In a recorded telephone conversation, the first defendant told his broker that he obtained the information from the board of directors of the company. The ACRSD asserted that all directors are insiders and there is no need to specifically know which one disclosed the information.[1573]

In 2015, the ACRSD revisited this issue of whether it is required to prove that an outsider violated the regulations of illegal corporate insider trading by receiving information from an insider.[1574] The facts of this case involved an allegation by the CMA

[1570] *Id*.
[1571] *Id*. at P. 23.
[1572] *Id*. at 23.
[1573] *Id*. at P. 21.
[1574] ACRSD, Decision No.974/ L.S/ 2015 of 1437 H, *supra* note 1453.

that an outsider traded on inside information in violation of Article (6)(b) of the MCR.[1575] The allegation stated that the defendant purchased a large number of shares of a listed company in 2010 before the announcement of paying dividends and sold all the purchased shares after the announcement. Again in 2011, the defendant purchased a large number of shares in the same company before the announcement of paying dividends. After the public disclosure, the defendant sold all his stocks in this company.[1576] However, the CRSD acquitted the defendant from illegal corporate insider trading liability, and the CMA appealed against the decision.[1577] The judgment rendered by the CRSD was based on the absence of evidence showing that the defendant was an insider or an outsider who received the information from an insider.[1578] The CRSD rejected the CMA's argument regarding the broad scope of Article (6)(b) of the MCR, and stated that Article (6)(b) must be read in connection with the other provisions, in particular, Article (50)(b) of the CML.[1579]

The CMA claimed before the ACRSD that the CRSD's decision was invalid because it erred in the interpretation of the regulations.[1580] The CMA stated that under Article (50)(c), the CRSD ignored that the CMA has the authority to specify and identify the terms stated in paragraphs (a) and (b) of this article.[1581] These paragraphs shows that the CMA has the right to issue executive regulations and rules that interpret and detail the forms and rules that apply to the prohibition under Article (50) of the CML. These forms and conduct include all possible scenarios when inside information may be exploited.[1582]

[1575] *Id*. at P. 1.
[1576] *Id*.
[1577] *Id*. at P. 4.
[1578] *Id*.
[1579] *Id*. at P. 5.
[1580] *Id*. at P. 4.
[1581] *Id*.
[1582] *Id*.

The CMA indicated that Article (6)(b) of the MCR aims to criminalize trading on inside information by outsiders when they receive inside information from another person not only from an insider as the CRSD's decision implies.[1583] The CMA stressed that the defendant admitted that he received information from some friend and did not remember his name but the information he obtained was specific.[1584] He also admitted that he did not know that the information he received was inside information, and if he had known, he would not have traded on that information.[1585] The defendant also offered to settle the case with the CMA.[1586] Applying these facts to Article (6)(b), the CMA stated that Article 6(b) of the MCR has two parts: (1) it prohibits non-insiders from trading on inside information and the defendant was a non-insider who traded on inside information; and (2) the information was obtained from another person.[1587] It was proven that he traded on inside information obtained from a friend. Therefore, there was no requirement that the person obtained the information from an insider.[1588] The CMA interpreted the term "another person" as defined under the Glossary of Defined Terms Used in the Regulations and Rules of the Capital Market Authority.[1589] A person means: "Any natural or legal person recognized as such under the laws of the Kingdom."[1590]

The ACRSD ruled that it is required in order to prove the violation of trading on inside information according to Article (50) of the CML and Article (6)(b) of the MCR to include the following elements: (1) trading by an insider or non-insider directly or

[1583] *Id*.
[1584] *Id*. at P. 6.
[1585] *Id*. at P. 7.
[1586] *Id*.
[1587] *Id*. at P. 5.
[1588] Id.
[1589] Glossary of Defined Terms, *supra* note 1393.
[1590] *Id*; ACRSD, Decision No.974/ L.S/ 2015 of 1437 H, *supra* note 1453, at P. 5.

indirectly on inside information; and (2) the person trading knows that the information is inside information which requires the satisfaction of the general criminal intent that he knows he is in possession of inside information and he desires to exploit such information before public disclosure.[1591] Based on the presented evidence, the ACRSD concluded that the defendant had traded on inside information in violation of Article (50) of the CML and Article (6)(b) of the MCR.[1592] The ACRSD based the conviction on the proof that the defendant acknowledged that he obtained inside information from some friend, and the information was specific and reliable. The defendant's trading pattern was suspicious in that he only purchased shares two times in the same company's stock and sold them after the public disclosure.[1593]

The ACRSD, however, did not explain how an outsider is liable for trading on inside information received from an outsider. This decision apparently does not require that an outsider trading on inside information must receive the information from an insider. In this case, it can be argued that the ACRSD concluded from the evidence that the nature of the information and the trading pattern in addition to other presented evidence reasonably led to the conclusion that the information originated from an insider even though the insider was not named in the case. Had the information not been specific or the defendant had denied that he received the information from someone, it would have been difficult for the CMA to prove that the trading was based on inside information. Nevertheless, the ACRSD's conclusion does not seem to be based on finding that the information originated from an insider.

[1591] *Id*. at P. 13.
[1592] *Id*.
[1593] *Id*. at P. 15-16.

Definition of Inside Information

The core element of illegal corporate insider trading liability is that the trading is based on obtained inside information. Although companies' insiders are presumed to always be aware of the internal affairs of the company they serve, they are only prohibited from exploiting certain information, for trading purposes, that meets the statutory requirements of inside information.[1594] In addition, this prohibition is temporary until this defined inside information is released to the public. Therefore, the ACRSD has asserted that the protection of inside information starts from the time an insider obtains such information until it is disclosed publicly for the purpose of leveling the field between general investors and insiders regarding the investment decision-making.[1595]

Article (50)(a) of the CML defines inside information as:

> information obtained by the insider and which is not available to the general public, has not been disclosed, and such information is of the type that a normal person would realize that in view of the nature and content of this information, its release and availability would have a material effect on the price or value of a Security related to such information.[1596]

Article (4) (c) of the MCR also defines inside information by stating that:

> For greater certainty, inside information means information that fulfils the following: 1) Information that relates to a security; 2) That has not been disclosed to the general public, and that is not otherwise available to the general public; and 3) That a normal person would realise that, in view of the nature and content of the information, disclosing it or making it available to the public would have a material effect on the price or value of the security.[1597]

These Articles define inside information by providing objective characteristics used to determine whether one piece of information is inside information, whether according to the law or based on the circumstances of the obtained information. In general, there are three characteristics of inside information, stated under these Articles, are three

[1594] *See* CML, *supra* note 152, art. 50(a); MCR, *supra* note 156, art. 4(c).
[1595] ACRSD, Decision No.147/ L.S/ 2009 of 1430 H, *supra* note 1456, at P. 22.
[1596] CML, *supra* note 152, art. 50(a).
[1597] MCR, *supra* note 156, art. 4(c).

characteristics as follows: (1) the information is related to a security; (2) it has not been available to the general public; and (3) it is material.[1598] These characteristics are discussed below.

Related to a Security

Article (50)(a) of the CML and Article (4)(c) of the MCR require that the information protected from exploitation must be information related to a security.[1599] Article 4(a) of the MCR defines the meaning of this requirement of which the related security "must be a traded security…whose price or value would be materially affected if the information was disclosed or made available to the general public."[1600] The CMA also defines "traded security" as "a security traded in the exchange."[1601]

This characteristic concerns the object of which the information can be exploited under the scope of the prohibition of illegal corporate insider trading. Inside information is exploited by the purchase or sale of a certain traded security related to inside information, in which the disclosure of such information would materially impact the price of the security in question. [1602] Therefore, the exploitation of inside information that is related to an untraded security is excluded from the prohibition boundaries. In addition, information that the issuer is permitted to keep secret and is undisclosed to the public is considered to

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[1598] *See* ACRSD, Decision No.146/ 2009 /ل.س of 1430H, *supra* note 1457, at P. 9.
[1599] Article (2) of the CML states that the term "securities" must include: "(a) Convertible and tradable shares of companies; (b) Tradeable debt instruments issued by companies, the government, public institutions or public organizations; (c) Investment unites issued by investment funds; (d) Any instruments representing profit participation rights, any rights in the distribution of assets; or either or the foregoing; (e) Any other rights or instruments which the Board determines should be included to treated as securities if the Board believes that this would further the safety of the market or the protection of investors…" CML, *supra* note 152, art. 2.
[1600] MCR, *supra* note 156, art. 4(a)(2).
[1601] Glossary of Defined Terms, *supra* note 1393.
[1602] *See* Metwally, *supra* note 1489, at 21.

have no impact on the related traded security even though it is confidential. For example, it could include patents, trade secrets, and other confidential information that the issuer is legally permitted to keep secret and undisclosed.[1603]

Article (4)(a)(5) of the MCR expressly states that illegal corporate insider trading occurs if the trading is "directly or indirectly effected in a security related to inside information."[1604] The same Article determines that the trading is considered to be direct in a security if the trader "execute[s] a trade in the security for any account in which he has an interest; or if [the trader] makes a bid or offer on the Exchange for the security."[1605] It defines the situations that constitute indirect trading in a security as follows: (1) if the trader "executes a trade as agent for another person;" (2) if the trader "arranges a trade to which a relative or person with whom he has a business or a contractual relationship is party; or (3) if the trader "arranges for his agent or any other person acting on his behalf or at his direction to trade in the relevant securities."[1606]

<u>Non-Public Information</u>

Article (50)(a) of the CML determines that inside information "is not available to the general public, [and] has not been disclosed."[1607] Article (4) of the MCR also describes inside information as information that "has not been disclosed to the general public, and that is not otherwise available to the general public."[1608] This means that inside information is non-public if it is in the hands of people bound by the duty of confidentiality and not yet

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[1603] *Id*.
[1604] MCR, *supra* note 156, art. 4(a)(5).
[1605] *Id*. art. (4)(a)(3).
[1606] *Id*. art. 4(a)(4).
[1607] CML, *supra* note 152, art. 50(a).
[1608] MCR, *supra* note 156, art. 4(c)(2).

released to the general public.[1609] Therefore, if the information is only known by people entrusted to keep the information in confidence, the information is non-public no matter how many people know about the information.[1610] The requirement that the information must be non-public information is imposed because the subject of illegal insider regulations is to prevent the exploitation of confidential information, in which it gives the trader an informational advantage to more accurately appraise the future value of the related security.[1611] Non-public information can be defined as any information that is related to the issuer's financial and managerial status or to the issuer's security itself, and such information, which the issuer is required to disclose, has not yet been released to or known by the general public.[1612]

The CML and CMA's implementing regulations treat non-public information related to the issuer's earning power and its business and managerial developments as confidential information prohibited from being disclosed to outsiders not bound by a duty of confidentiality until such information is disclosed through the regulatory means.[1613] The CMA has also asserted that the duty to disclose non-public information and to maintain the

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[1609] *See* Al-Nufi, *supra* note 1454, at 150; Al-Othman*, supra* note 1478, at 340.

[1610] Farghaly*, supra* note *1474*, at 12.

[1611] ACRSD, Decision No.148/ L.S/ 2009 of 1430 H, *supra* note 1501, at P. 10. (The CMA asserted that the knowledge of inside information gives the insider "an advantage over others that would enable him to approach the proper evaluation of share's market value expected in the near future.") *Id*.

[1612] *See* Farghaly*, supra* note *1474*, at 11-12. *See* also ROSCO, *supra* note 157, arts. 62, and 63.

[1613] Article (45)(c) of the CML considers information and data related to the annual and quarterly reports of the issuer that relates to (1) the balance sheet; (2) the profit and loss account; (3) the cash flow statement; and (4) "an evaluation of the issuing company management of current and future developments and any future possibilities that may have significant effect on the business results or financial position of the company" as confidential information before this information is disclosed to the CMA. CML, *supra* note 152, art. 45(c). This Article also requires the issuer to prevent any "disclosing of such information to parties not bound by a confidentiality obligation and obligation to protect such information." *Id*. In addition, Article (46)(a) of the CML requires issuers to disclose to the CMA once such issuer becomes "aware of any material developments which may affect the prices of the Securities issued by such party. If such party has a Security traded on the Exchange, the Exchange must be informed of such developments in writing." Id. art. 46(a). *See* also the *ROSCO*, *Id*. arts. 61, 62, 63, and 64.

confidentiality of such information before public disclosure and illegal corporate insider trading liability is connected and indistinguishable.[1614] This connection comes from the notion that illegal corporate insider trading regulations aim to prohibit the misuse and exploitation of inside information for trading purposes before the information becomes public through regulatory methods of disclosure. Therefore, "the misuse of information not-disclosed by statutory means makes such information inside and confidential."[1615]

Rumors and Unspecific Information v. Non-public Information

Another question that can be raised under the definition of non-public information is whether non-public information must also be specific and not based on rumors and unverified news to constitute non-public information that is subject to exploitation. Many commentators suggest that the content of the information that is related to the traded security of the issuer must lead to a realization of the occurrence of a specific event either at the current time or in the future.[1616] General or speculative information that is not supported by facts, such as the company is experiencing its greatest prosperity, is not considered non-public information because it lacks the necessary specificity and because the person obtaining such information would still undertake substantial economic risk if he/she decided to trade based on this information.[1617] Therefore, the unfair informational advantage is absent. This suggestion also applies to rumors and circulating news, in which a person who hears rumors or unverified news is not prohibited from trading on such

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[1614] ACRSD, Decision No.974/ L.S/ 2015 of 1437 H, *supra* note 1453, at P. 5.
[1615] *Id*.
[1616] *See* Farghaly*, supra* note *1474*, at 12.; Al-Nufi, *supra* note 1454, at 157; Al-Othman*, supra* note 1478, at 340; Metwally, *supra* note 1489, at 21.
[1617] *Id*.

information since it is not protected under illegal corporate insider trading regulations.[1618] One commentator suggested that this analysis can be inferred from the requirement under Article (50)(a) of the CML that non-public "information is of the type that a normal person would realize that in view of the nature and content of this information..."[1619] This phrase implies that the content and nature of the information must be specific and have a determinative value of whether it is non-public information; thus, it is protected under Article (50) of the CML.[1620]

Trading outsiders who deny obtaining inside information from an insider typically cite the availability of rumors and speculative news as a defense in illegal corporate insider trading cases. In 2009, the ACRSD accepted an outsider defendant's allegation that his trading was based on rumors and speculative news that flourished within the investment community and he did not obtain non-public information from his brother, who was the chairman of the issuer of the security related to the information in question.[1621] The ACRSD acknowledged that rumors were spreading on the Internet about an increase in the company's capital which led to an increase in the market price of the company's stock.[1622] The ACRSD concluded that the increase of the market price of the stock was because of the rumors and the circulated news attracted investors to trade.[1623] Therefore, under such circumstances, the presumption of obtaining inside information is weakened.[1624]

[1618] Id.
[1619] CML, *supra* note 152, art. 50(a).
[1620] Farghaly*, supra* note *1474*, at 13.
[1621] *See* ACRSD, Decision No.148/ L.S/ 2009 of 1430 H, *supra* note 1501. (The information was about an imminent conclusion of an acquisition transaction of another company.) *Id*. at P. 6.
[1622] *Id*. at P. 21.
[1623] *Id*.
[1624] *Id*. at P. 22.

In another case in 2015, however, the ACRSD found an outsider liable for trading on inside information related to the announcements of paying dividends even though the defendant denied receiving the information from an insider but claimed he overheard it while at a gathering of friends.[1625] The ACRSD concluded that the conviction of the defendant under Article (6)(b) of the MCR was based on the reoccurring trading patterns of the defendant in the same company's stock before the two announcements of paying dividends in 2010 and 2011, and he did not trade in this stock between these periods. In addition, the defendant admitted that he received specific information two different times from persons who did not remember sitting with a group of friends.[1626]

<u>Article (6)(b) of the MCR does not Require Non-public Information to be Obtained from an Insider</u>

As discussed above, Article (6)(b) of the MCR does not require that an outsider has some knowledge that the non-public information is obtained from an insider or originated from an insider.[1627] As a result, the CMA decided that Article (6)(b) of the MCR makes it unlawful for any person to trade on inside information obtained from any other persons (insiders or outsiders, and known or unknown) if the person receiving the information knows or should know that the information is inside information.[1628] This interpretation by the CMA can mean that investors who obtain information by any means, including social media apps, are required to investigate whether the obtained information is non-public and prohibited to be used under Article (50)(a) of the CML or not. Therefore, it can be argued

[1625] ACRSD, Decision No.974/ L.S/ 2015 of 1437 H, *supra* note 1453, at P. 17.
[1626] *Id*. at P. 16.
[1627] *See supra* notes 143-185 and accompanying text.
[1628] *See* ACRSD, Decision No.974/ L.S/ 2015 of 1437 H, *supra* note 1453, at P. 3; ACRSD, Decision No.146/ 2009 /ل.س of 1430H, *supra* note 1457, at P. 13.

that this prohibition is broad and makes illegal corporate insider trading regulations uncertain. In particular, it can include legal trading within the realm of illegal corporate insider trading prohibition.[1629] This uncertainty can be illustrated as follows:

1- Article (6)(b) of the MCR does not take into consideration that when information including non-public information is transferred between many people, there is a high likelihood that the information obtained by the trading outsider would lose specificity and even accuracy.[1630] Therefore, it is impractical to require a trading outsider to inquire about the specificity and accuracy of the information, or examine whether the information is non-public or not as described under Article (50)(a) of the CML and Article (4)(c) of the MCR.

2- When a trading outsider decides to trade based on rumors or unverified news circulating on the Internet, he/she would take a considerable risk that the information may turn out to be untrue. Thus, such a trading outsider would not have the unfair informational advantage that illegal corporate insider trading is prohibited. Even if the content of the rumor reflects true non-public information, it is not likely to be considered non-public at this stage.[1631]

3- This Article does not distinguish between sophisticated and unsophisticated investors in terms of the ability to distinguish between non-public information and mere speculative news. Sophisticated investors are more capable of realizing that the information obtained is non-public information based on their

[1629] *See* Al-Nufi, *supra* note 1454, at 186.
[1630] *See Coles*, *supre* note *822*, at 215.
[1631] *See LANGEVOORT, supra* note *6, at* §5:6.

knowledge and experience. However, unsophisticated investors are more likely to fail to distinguish between speculative news received from friends and non-public information that is protected from exploitation under Article (50) of the CML.[1632]

Non-public Information Becomes Public

The prohibition of trading on inside information ends when the information becomes public. Thus, the determination of whether or not the information is non-public has a determinative outcome in illegal corporate insider trading liability.[1633] Article (50) of the CML and Article (4) provide two possible ways in which information becomes public: (1) when the information is disclosed through regulatory methods of disclosure; or (2) the information is available to the general public through any other method of disclosure.[1634] One commentator described this regulatory approach as a mix between a restricted approach that only recognizes information as public when the information is disclosed through recognized means, and a flexible approach that focuses on the availability of the information to the public disregarding the method of disclosure.[1635]

Public release of the information by recognized methods undisputedly converts the information from non-public to public information so it can legally be used for trading purposes. In a case before the ACRSD, the CMA asserted that the purpose of Article (50) of the CML is to protect inside information from any misuse or exploitation at the time that such information has not been disclosed to the public or made available to the public

[1632] *See* Al-Nufi, *supra* note 1454, at 186.
[1633] *See* Farghaly*, supra* note *1474*, at 12.
[1634] CML, *supra* note 152, art. 50(a); MCR, *supra* note 156, art. 4(c)(2).
[1635] Al-Nufi, *supra* note 1454, at 154.

through the regulatory methods set by the CMA and Exchange.[1636] The CMA states that the regulatory methods of disclosure are two exclusive methods: (1) disclosing the information in a continuous manner according to the continuous disclosure rules; or (2) disclosing the information in the periodic financial statements as well as the annual board reports.[1637] According to the CMA's implementing regulations and the Exchange's rules, any public disclosure by an issuer must be filed through the electronic system designated by the Exchange.[1638]

On many occasions, the ACRSD has asserted that the protection of inside information in terms of time starts once a person obtains the information until the time of public disclosure.[1639] However, it remains unclear whether non-public information can

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[1636] ACRSD, Decision No.974/ L.S/ 2015 of 1437 H, *supra* note 1453, at P. 5.

[1637] *Id*. *See* CML, *supra* note 152, arts. 45(c), and 46(a). (Article (45) of the CML obliges listed companies to disclose quarterly and annual reports. Information regarding the financial condition of the issuer, its directors and management, and management forecast is protected under paragraph (c) of this Article as is deemed confidential, and the issuer is prohibited from disclosing the information to other parties not bound by the confidentiality obligation before disclosing the information to the CMA. Article (46)(a) of the CML imposes upon issuers a duty to continuously update the CMA in writing once the issuer becomes "aware of any material developments which may affect the prices of the securities issued by such party. If such party has a Security traded on the Exchange, the Exchange must be informed of such development in writing.") *See* ROSCO, *supra* note 157, art. 62. (Article 62 of ROSCO states that: "An issuer must disclose to the Authority and the public without delay any material development in its sphere of activity which are not public knowledge, and which may affect the assets and liabilities or financial position or the general course of business of the issuer or its subsidiaries and which may reasonably lead to movements in the price of the issuer's listed securities or significantly affect an issuer's ability to meet its commitments in respect of list debt instruments.") *See* LR of 2017, *supra* note 158, art. 30. (Article (30) of the Listing Rules states that "an issuer is required to make a disclosure to the public as soon as possible following the occurrence of an event that is required to be disclosed pursuant to any applicable continuing obligation set out in the Implementing Regulations and the Exchange Rules. In all cases, the disclosure has to be made before the start of the trading period that follows the occurrence of the relevant event.") *id*.

[1638] ROSCO, *supra* note 157, arts. 61(a), and (64)(b). (Article (61)(a) of the ROSCO states that: "All disclosures made by an issuer must be complete, clear, and accurate and not misleading and shall comply with the means of disclosure specified by the Exchange in the Listing Rules." In addition, Article (64) of the ROSCO states that: "The issuer shall disclose its interim and annual financial statement through the electronic system specifically designated for such purpose by the Exchange.") Article (29)(a) of the Exchange's Listing Rules states that: "All notifications to the Exchange and Disclosures to the public by an issuer must be in Arabic, the issuer may translate them to English, and must be made through the system specifically designated by the Exchange for such purpose." LR of 2017, *Id*. art. 29(a).

[1639] ACRSD, Decision No.147/ L.S/ 2009 of 1430 H, *supra* note 1456, at P. 22.

become public for the purpose of illegal corporate insider trading regulations if the information has been revealed to the public through non-regulatory designated means. For instance, it is unclear whether a press statement by the issuer through a national newspaper is adequate to consider the information available to the public. It is certain, however, that disclosing inside information before filing the information with the CMA is a violation of Article (45)(c) of the CML.[1640] The CMA has actively enforced this prohibition against even press statements or interviews made by listed company officials where a new development has been disclosed before notifying the CMA.[1641] In one case, the CMA asserted that disclosing non-public information to a news reporter was in violation of the prohibition of disclosing inside information under Article (5)(a) of the MCR. However, the ACRSD reversed the decision of CMA and asserted that disclosing non-public information through a media press is not actionable under illegal corporate insider trading regulations.[1642]

According to the available data of illegal corporate insider trading cases, there has been no case where a defendant has alleged the availability of information to the public through nontraditional public disclosure, such as a press statement. However, it can be inferred from the definition of inside information under Article (4)(c)(2) of the MCR that non-public information can become public if it is disclosed through nationwide news media

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[1640] *See supra* note 229.
[1641] *See* ACRSD, Decision No. 417/L.S/2011 of 1433 H. season of 2/2/1433H (corresponding to Dec 27, 2011), http://www.crsd.org.sa/en/AppealsCommittee/Decisions/Documents/417-33E.pdf. (The case involved a grievance claim by a listed company against the CMA Board's decision imposing a fine on the company of an amount equal to SR. 200,000 ($53.333) for a press statement made by the company's chairman to a national newspaper before disclosing this information to the CMA. The disclosed information was that the board of directors decided to pay interim dividends to the shareholders. The ACRSD rejected the company's claim and endorsed the CMA Board's decision.) *Id*. at 2.
[1642] ACRSD, Decision No.424/ L.S/ 2012 of 1433 H, *supra* note 1526, at P. 4.

in which the availability of the information to the general public is accomplished even though the disclosure is in violation of other provisions of the CML since the goal of equal access to information is fulfilled.[1643]

Material Information

The Saudi Arabian regulators have realized that not all non-public information related to a traded security must be subject to the prohibition of trading on inside information.[1644] Therefore, Article (50) of the CML states that inside information must be material, which means the information "is of the type that a normal person would realize that in view of the nature and content of this information, its release and availability would have a material effect on the price or value of a Security related to such information."[1645] Article (4) of the MCR also requires that inside information must be information "that a normal person would realise that, in view of the nature and content of the information, disclosing it or making available to the public would have a material effect on the price or value of the security."[1646]

The adopted materiality standard is that non-public information is material if it would objectively and significantly impact the price or value of the related security because of the public disclosure of such information.[1647] This is what Article (4)(a)(2) of the MCR indicates by defining a security related to inside information. This Article states that: "A security related to inside information shall mean any security whose price or value would

[1643] Article (4)(c)(2) of the MCR defines non-public information as information "has not been disclosed to the general public, and that is not otherwise available to the general public." MCR, *supra* note 156, art. 4(c)(2). *See* Al-Nufi, *supra* note 1454, at 153. *See* also Metwally, *supra* note 1489, at 14.
[1644] Farghaly*, supra* note *1474*, at 15.
[1645] CML, *supra* note 152, art. 50(a).
[1646] MCR, *supra* note 156, art. 4(c)(3).
[1647] *See* Farghaly*, supra* note *1474*, at 15.

be materially affected if the information was disclosed or made available to the general public."[1648]

To determine whether the information is material because of its disclosure would have a material effect on the related price or value of a security, Article (50)(a) of the CML and Article (4)(c)(3) of the MCR provides an objective test based on a normal person's perspective of whether the information is material or not.[1649] A reasonable person's standard determines whether the information is material or immaterial based on the content and nature of the information itself regardless of whether the person receiving the information treats it as such if, as a matter of law or under the circumstances, it is material information.[1650]

<u>CMA's Determination of Material Information</u>

In addition to the requirement of making periodic reports and to accomplish CML's goal of full disclosure, the CMA imposed two duties of continuous disclosure upon issuers. First, under Article 62 of the ROSCO, the CMA requires issuers to publicly disclose material developments, under the assessment of the issuer, at the time they are discovered and without delay.[1651] Furthermore, Article (63) of the ROSCO necessitates prompt disclosure of specific developments and events notwithstanding the issuer's assessment

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[1648] MCR, *supra* note 156, art. 4(a)(2).
[1649] *See* Farghaly*, supra* note *1474*, at 16; Metwally, *supra* note 1489, at 19; Al-Nufi, *supra* note 1454, at 155.
[1650] *See* Farghaly*, supra* note *1474*, at 17.
[1651] ROSCO, *supra* note 204, art. 62(a) (Under this article, material developments that must be disclosed are any new event that is not already known by the general public, and may affect the assets and liabilities or financial position of the issuer that may reasonably lead to a change in the price of the related security or would significantly affect the issuer's ability to fulfill its commitment related to listed debt instruments. For the purpose of determining whether the information is material, issuers are required to "assess whether a prudent investor would be likely to consider information about the development in making his investment decision.") *Id*.

about the materiality of such events.[1652] This Article enumerates 27 specific events that cover most of the issuer's business operations and management developments in addition to matters affecting the life-cycle of the issuing company.[1653]

[1652] ROSCO, *supra* note 204, art. 63.

[1653] These 27 specific events are as follows: "1) any transaction to purchase, sell, lease or mortgage an asset at a price equal to or greater than 10% of the net assets of the issuer according to the latest reviewed interim financial statements or audited annual financial statements, whichever is later; 2) any debt outside the issuer's ordinary course of business, of a value equal to or greater than 10% of the issuer's net assets; according to the latest reviewed interim financial statements or audited annual financial statements, whichever is later; 3) any losses equal to or greater than 10% of the issuer's net assets; according to the latest reviewed interim financial statements or audited annual financial statements, whichever is later; (4) any significant change in the issuer's production environment or activity including (but not limited to) the availability of resources and the possibility of obtaining them; 5) any changes in the composition of the directors, the audit committee or to CEO's position of the issuer, and in case the issuer is a special purposes entity, any changes in the composition of the directors, the audit committee or to CEO's position of the sponsor and the special purposes entity; 6) any dispute including any litigation, arbitration, or mediation where the value involved is equal to or greater than 5% of the net assets of the issuer according to the latest reviewed interim financial statements or audited annual financial statements, whichever is later; 7) any judicial decision issued against the board or any of the directors where the subject of the decision involved relates to the business of the board or any of the directors in the issuer; 8) the increase or decrease in the net assets of the issuer equal to or greater than 10% according to the latest reviewed interim financial statements or audited annual financial statements, whichever is later; the increase or decrease in the gross profit of the issuer equal to or greater than 10% according to the latest audited financial statements; 10) the entering into, or the unexpected termination of, any contract with revenues equal to or greater than 5% of the gross revenues of the issuer according to the latest audited annual financial statements; 11) any transaction between the issuer and a related party or any arrangement through which the issuer and a related party invest in any project or asset or provide financing therefore if this transaction or arrangement is equal to or greater than 1% of the gross revenues of the issuer according to the latest audited annual financial statements; 12) any interruption in the principal activities of the issuer or its subsidiaries equal to or greater than 5% of the gross revenues according to the latest audited annual financial statements; 13) any changes in the issuer's articles of association or the location of the issuer's principal office; 14) any change in its external auditors; 15) the presentation of any winding-up petition, the making of any winding-up order or the appointment of a liquidator in respect of the issuer or its affiliates under the Companies Law, or the commencement of any proceedings under the Bankruptcy Regulations; 16) the passing of a resolution by the issuer or its affiliates that it be dissolved or liquidated, or the occurrence of an event or termination of a period of time which would require the issuer to be put into liquidation or dissolution; 17) the making of any judgement, decision, order or declaration by a court or judicial body, whether at first instance or on appeal, which may adversely affect the issuer's utilisation of any portion of its assets which in aggregate value represents a value in excess of 5% or more of the net assets of the issuer according to the latest reviewed interim financial statements or audited annual financial statements, whichever is later; 18) the call for convening a general or special assembly and its agenda; 19) the outcome of the general or special assembly; 20) any proposed change in the capital of the issuer; 21) any decision to declare, recommend to declare or pay dividends or to make any other distributions to the holders of its listed securities; 22) any decision or a recommendation not to pay dividends which would otherwise have been expected to have been paid; 23) any decision to call, repurchase, draw, redeem or propose to buy any of its securities and the total amount and value thereof; 24) any decision not to make payment in respect of debt instruments or convertible debt instruments; or 25) any change in the rights attaching to any class of listed shares or to the debt instruments convertible to such shares. 26) If the issuer is a special purposes entity, any court proceedings taken or threatened against the special purposes entity, any criminal or disciplinary procedures or sanctions to be inflicted on or likely to be inflicted on the special purposes entity. 27) If the

The CMA believes that the issuers' duty to disclose relevant information imposed under the CML and its implementing regulations is to fulfill the policy of full disclosure to give public investors adequate information to make their investment decisions in view of equal access to sensitive price information related to traded securities.[1654] The idea is that any misuse of inside information before public disclosure is in violation of the essence of the CML and its implementing regulations.[1655] Therefore, the CMA has considered that any information an issuer is required to disclose is either related to periodic reports or to continuous disclosure. Thus, a twofold paradigm is material regarding illegal corporate insider trading liability.[1656]

In illegal corporate insider trading cases, the issue of materiality of non-public information has been presumed to suffice with little discussion. The CMA and ACRSD approved the satisfaction of the materiality element of inside information by the issuing company disclosing the information to the public and presuming the information disclosed meets the materiality requirement laid out under Article (50)(a) of the CML and Article (4)(c) of the MCR.[1657] When the element of materiality was discussed, it was enough for the ACRSD to indicate how the public disclosure of such information would affect the issuer's financial condition or its business growth and the subsequent result on the value

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issuer is a special purposes entity, any court proceedings taken or threatened against members of the board of directors of a special purposes entity, any criminal or disciplinary proceedings or sanctions to be inflicted on or likely to be inflicted on members of the board of directors of the special purpose entity, If the subject matter of the procedure or sanction relates to the work of the Board of Directors or one of its members in the Special Purpose Entity." *Id*.

1654 *See* ACRSD, Decision No.973/ L.S/ 2015 of 1437 H, *supra* note 1452, at P.15; ACRSD, Decision No.974/ L.S/ 2015 of 1437 H, *supra* note 1453, at P. 5-6.

1655 *Id*.

1656 *Id*.

1657 For example, *see* Decision No.974/ L.S/ 2015 of 1437 H, *supra* note 49, at P. 4-5, 15-16; ACRSD, Decision No.424/ L.S/ 2012 of 1433 H, *supra* note 1526, at P. 2; ACRSD, Decision No.147/ L.S/ 2009 of 1430 H, *supra* note 1456, at P.13, 19-20.

of the issuer's security. In one case, the materiality element of disclosed information was approved by referring to the issuer's statement about the effect of such information.[1658] In this case, the announcement about a real estate sale included the following statement: "the company would achieve…a gain of (SR77.500,00). Such gain would positively affect the results of the fourth quarter of the year 2010, increase the rights of shareholders and provide the liquidity that would contribute to implementing company's future investments and projects."[1659]

Market Reaction after Public Disclosure

Although the focus in illegal corporate insider trading cases before the ACRSD is on the fundamental effect of the issuer's disclosure on the value of the traded security, the reaction of the market price is a statutory measure to determine the materiality of information. Article (50)(a) plainly states that the materiality standard is determined by inquiring whether a reasonable person would view the disclosure of the information to the public as having "a material effect on the *price* or value of a Security related to such information."[1660] Thus, a reflection in the market price because of the information disclosed is an important aspect to determine the materiality of the information.[1661] The CMA has used the market price reaction after the disclosure to calculate the profits gained or loss avoided by the defendant from trading on inside information.[1662] In one case, the ACRSD analyzed the materiality of information in question based on the market price reflection

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[1658] ACRSD, Decision No.973/ L.S/ 2015 of 1437 H, *supra* note 1452, at P. 20.
[1659] *Id*.
[1660] CML, *supra* note 152, art. 50(a).
[1661] *See* Farghaly*, supra* note *1474*, at 15.
[1662] ACRSD, Decision No.974/ L.S/ 2015 of 1437 H, *supra* note 1453, at P.1.

after the public disclosure.[1663] In this case, the defendant's attorney unsuccessfully tried to undermine the materiality of the information in question.[1664] The attorney stated that the disclosed information about the board of directors' decision to raise the workforce development program expenses allocated to the fourth quarter of 2004 from SR37.5 million ($19.6 million) to SR467.5 million ($124.666 million) was immaterial since the 2004 profits at the announcement of financial results were higher than the profits of 2003.[1665] In addition, the attorney argued that it was uncertain whether or not the decrease of the stock price after the public disclosure was due to the information in question.[1666] However, the ACRSD rejected the defendant's attorney's argument and asserted that the Article (50)(a) test of materiality was linked to a prudent person's realization of the information's significant impact on the price or value of a security.[1667] The ACRSD found that since the stock market price decreased by 6.8 percent compared to the closing price of the previous day before the public disclosure, it was enough to prove materiality where no other factors were proved to contribute to the adverse impact of the stock price after the public announcement of the financial results.[1668]

<u>Must Material Information be Certain?</u>

The statutory definition of inside information, under Article (50)(a) of the CML, apparently does not require that for the information to be material it must be certain that it will occur.[1669] In fact, the statutory definition hinges on finding materiality on a significant

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[1663] ACRSD, Decision No.229/ L.S/ 2010 of 1431 H, *supra* note 1404.
[1664] *Id*. at P. 4.
[1665] *Id*.
[1666] *Id*.
[1667] *Id*. at P. 6.
[1668] *Id*. at 6.
[1669] *See* CML, *supra* note 152, art. 50(a).

effect of the information after public disclosure on the price or value of the related security.[1670] This means that based on an objective assessment of its disclosure or availability to the general public, information is material inside information if the information is related to a security and its public disclosure would significantly affect the price or value of the related security, even if a price change is uncertain to occur.[1671] However, part of the objective assessment of the materiality of information in question is based on whether it is more likely than not that the information will occur. When the information is more unlikely to occur, it is not required to be publicly disclosed since an effect on the price or value of the related security is unlikely. However, there is no clear legal standard to determine when a future event will probably occur.

Illegal insider trading cases tried before the ACRSD show that the probability of the occurrence of an event is most likely to be an issue related to mergers and acquisitions. In one case, the ACRSD concluded that information was material if it involved the knowledge of the defendant (the vice president of the company) about a management memorandum that would be presented to the board of directors. The memorandum would request a feasibility study and recommend financial advisors to conduct the study on converting some affiliated companies to a joint stock company or merging them into the parent company, and to determine the capital increase accordingly and recommend hiring financial advisors to conduct the study.[1672] The defendant's attorney argued that the decision to conduct the study issued by the board of directors was immaterial because it

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[1670] *Id*.
[1671] *See* ACRSD, Decision No.146/ 2009 /ل.س of 1430H, *supra* note 1457, at P. 9.
[1672] ACRSD, Decision No.147/ L.S/ 2009 of 1430 H, *supra* note 1456, at P. 21.

was just a mandate to conduct a study not an approval of the conversion or the merger.[1673] The ACRSD rejected the attorney's argument and concluded that the request to conduct the study met the requirement of inside information.[1674] The ACRSD noted that the management memorandum was preceded by inviting financial advisors including their names in the minutes of the board. Thus, the information was not hidden from the defendant (as the vice president), so he was aware that he was in possession of inside information from the time he had knowledge of the request until the disclosure to the public.[1675]

Another case related to trading on inside information involving an acquisition transaction. The ACRSD concluded that the knowledge or expectation of an imminent approval of an acquisition deal by the board of directors of a listed company and the subsequent public disclosure was material inside information.[1676] The defendant's attorney unsuccessfully alleged that the acquisition negotiation, which his client (the chairman of the acquiring company) was authorized to conclude, was not material because it was mere negotiation and was uncertain to occur since it was conditioned on the approval of the board of directors.[1677] The attorney argued that the memorandum contained a term that allowed revocation or cancelation of the deal at any time. Therefore, the attorney claimed that his client's trading before the approval of the acquisition deal by the board of directors did not constitute illegal corporate insider trading because the information was immaterial.[1678] The ACRSD concluded that the deal of acquiring all proprietary rights of

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[1673] *Id*. at P. 5.
[1674] *Id*. at P. 20.
[1675] *Id*.
[1676]ACRSD, Decision No.148/ L.S/ 2009 of 1430 H, *supra* note 1501, at P. 19.
[1677] *Id*. at 6.
[1678] *Id*. (The facts of this case involved the following events: First, at the beginning of 2006, the negotiation started between the chairman's company to acquire all proprietary rights of another company. A memorandum of understanding was signed to authenticate the willingness of the two companies and their

another company is inside information meets all the requirements stated in Article (50)(a) of the CML and Article (4)(c) of the MCR.[1679] The ACRSD asserted that the inside information regarding this case constituted inside information from the time the defendant was authorized to complete the negotiation with the other company until the time of the public disclosure about the conclusion of the transaction.[1680]

The ACRSD, however, did not offer an express standard that would objectively determine when an expectation of the conclusion of merger and acquisition deals constitutes knowledge of inside information. What can be inferred from the ACRSD's decision is that an expectation of the occurrence of an acquisition or merger (which constitutes inside information) may be presumed to take place at any time—between the knowledge of one or more serious steps to prepare for a merger or an acquisition until any public disclosure of related information. These serious steps taken to prepare for a merger could include (1) knowledge about an imminent decision by the board of directors to

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consent to enter into negotiations about the acquisition of all proprietary rights of the other company and concluding the deal when there was consensus of all the terms of the deal. The signature of the memorandum of understanding was disclosed to the public. The board of directors of the acquiring company authorized the defendant (the chairman) to represent the company in the negotiation and to conclude the acquisition deal. The defendant purchased shares of his company. Next, the board of directors issued a decision to continue concluding the deal based on the offer presented by the other company and authorized the defendant to sign the memorandum of agreement. Later, the company disclosed to the public that the board of directors approved the acquisition of the entire proprietary rights of another company for an amount equal to SR273 million ($72,800 million).) *Id*. at P. 19.

1679 *Id*. at P. 19.

1680 *Id*. (In this case, the CMA asserted that the negotiation between the companies about the acquisition was emphasized by signing the memorandum of understanding. Thus, it met the requirements of inside information because the company publicly disclosed the negotiation and the signed memorandum of understanding. As the CMA stated, if the negotiation was immaterial, the company would not have had to disclose it to the public. *Id*. at P. 14. However, because the defendant's trading occurred after the disclosure of the acquisition negotiations, the inside information that was found to be misused was the expectation of imminent approval of the deal followed by public disclosure.) *Id*. at P. 19.

conduct a feasibility study,[1681] or (2) knowledge of a serious merger negotiation involving the signing of a memorandum of understanding.[1682]

Requisite State of Mind: The Possession vs. Actual Use of Inside Information

To avoid punishing innocent acts, the regulations consider illegal corporate insider trading as intentional criminal conduct. In fact, the requirement that the conduct of illegal corporate insider trading must be intentional is considered the legal element that restricts the range of liability of illegal corporate insider trading.[1683] The requisite state of mind required under the regulation of illegal corporate insider trading is the insider's knowledge that the information obtained is non-public and material.[1684] To establish illegal corporate insider trading liability, Article (50)(a) expressly requires that the insider "knows that such information is not generally available and that, if it were available, it would have a material effect on the price or value of such security."[1685]

The requisite culpable state of mind, termed "the moral element," is established based on the availability of the general criminal intent.[1686] This general criminal intent means that the insider must be aware that he/she is in possession of inside information that satisfies all of the legal characteristics required under Article (50)(a), and he/she willfully desires to exploit the information by trading in the related security while the obtained information is still unknown to the public.[1687]

[1681] *See* ACRSD, Decision No.147/ L.S/ 2009 of 1430 H, *supra* note 1456, at P. 20.
[1682] *See* ACRSD, Decision No.148/ L.S/ 2009 of 1430 H, *supra* note 1501, at P. 19.
[1683] Beach, *supra* note *153*, at 344.
[1684] *See Id.*
[1685] CML, *supra* note 152, art. 50(a).
[1686] *See* Farghaly*, supra* note *1474*, at 39; Al-Nufi, *supra* note 1454, at 186.
[1687] *See Id*; Nabeel Yousef Al-Samhan, *Insider's Penal Responsibility for the Inside information in Stock Exchange -A Comparative Study-*, 73 (2013-2014), https://meu.edu.jo/libraryTheses/587ddb4f44993_1.pdf. (Ar)

This standard of awareness and desire to exploit has been established to fulfill the moral element by the ACRSD and the CMA in illegal corporate insider trading cases. The CMA has asserted that illegal corporate insider trading is a willful and intentional violation that requires general criminal intent. In particular, the defendant is aware of possessing inside information that has not been disclosed to the public, and he/she deliberately exploits the information by trading or disclosing the information to others while the information is non-public.[1688] Similarly, the ACRSD has stated that, pursuant to Article (50)(a) of the CML and Article (6) of the CML, the required element is that the insider or outsider knows that the information he/she is trading on is based on inside information. Thus, this element is determined by the availability of the general criminal intent which includes both knowledge and desire. This requires that the person knowingly possesses inside information and knowingly exploits or uses this information before it becomes public knowledge.[1689]

Article (50)(a), however, does not expressly require actual knowledge of inside information. This allows the court to presume knowledge based on the availability of circumstances surrounding the trade in question.[1690] The ACRSD and CMA have applied a presumption of the fulfillment of this element when the conduct of trading on a security related to inside information occurs before the information is disclosed to the public, and where circumstantial evidence supports an inference of awareness and exploitation.[1691] In one case against a chairman of a listed company who purchased the company's stock before

[1688] *See* ACRSD, Decision No.973/ L.S/ 2015 of 1437 H, *supra* note 1452, P.5; ACRSD, Decision No.974/ L.S/ 2015 of 1437 H, *supra* note 1453, at P. 2.
[1689] ACRSD, Decision No.973/ L.S/ 2015 of 1437 H, *supra* note 1452, P. 21.
[1690] *Beach, supra* note *153*, at 344 Nt. 187.
[1691] *See* Al-Nufi, *supra* note 1454, at 182.

the disclosure of an acquisition deal, the ACRSD found that the moral element of illegal corporate insider trading was satisfied based on the following reasons: (1) the defendant was authorized by the board of directors to negotiate and close the acquisition deal; (2) the defendant failed to provide a reasonable explanation of his trading act that justified the purchase of his company's stock before the board of director's meeting and the public disclosure; and (3) the absence of any purchase trading by the defendant during the six months prior to the purchase.[1692] Therefore, the ACRSD concluded that the evidence revealed "the awareness of the defendant that he possessed inside information that had not been disclosed to the public, and his intent to utilize the information by the purchase of the company's stock during the period preceding the announcement to the public."[1693]

Another case involved an allegation against two directors of a listed company, who were also brothers, and four of their family members for trading on inside information and disclosure of the information related to a real estate sale of the company.[1694] The ACRSD determined fulfillment of the moral element based on the following presented evidence by the CMA: (1) the first defendant was a member of the executive committee in the listed company and was authorized to negotiate and sign the sale deal which informed him about concluding the deal per law; (2) the family relationship connected the defendants and the defendants' trading in a short period before the public disclosure; (3) most of the defendants purchased the company's stock after the company received a serious offer to purchase the company's real estate and before the public disclosure, and sold their entire holdings after the disclosure; (4) there were contradictory reasons and statements to the

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[1692] ACRSD, Decision No.148/ L.S/ 2009 of 1430 H, *supra* note 1501, at P. 19.
[1693] *Id*.
[1694]ACRSD, Decision No.973/ L.S/ 2015 of 1437 H, *supra* note 1452, P. 20.

CRSD by the trading relatives regarding their trading at the time of the investigation; and (5) the defendants did not make any trading transactions on the stock in question for at least six months prior to their trading in question.[1695]

The meaning of stating that the moral element is satisfied by the availability of general criminal intent is that the motivation or the goal of trading or disclosing inside information is irrelevant to find an insider liable.[1696] It is irrelevant whether the insider intended to personally gain illegal profit from the trade or whether the insider intended to donate the profit to charity.[1697] An insider would be held liable for disclosing inside information when he/she is aware that he/she is disclosing inside information to another while the information is non-public.[1698] Thus, it is irrelevant whether the disclosing insider would personally benefit from the disclosure or not.[1699]

The CMA, however, has realized that a general standard of awareness could unwittingly hinder financial institutions and other authorized persons' job of conducting their securities business.[1700] Therefore, the CMA's Authorized Persons Regulations of 2005 (APR), Article (30)(c) has provided an affirmative defense from illegal corporate insider trading liability under Articles (5) and (6) of the MCR. This defense applies to authorized persons or their employees acting on their behalf if they deal in or advise on a

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[1695] *Id*. P. 20.
[1696] ACRSD, Decision No.229/ L.S/ 2010 of 1431 H, *supra* note 1404, at P. 5. *See* Al-Nufi, *supra* note 1454, at 182.
[1697] *See* Al-Samhan, *supra* note 1687, at 74.
[1698] ACRSD, Decision No.148/ L.S/ 2009 of 1430 H, *supra* note 1501, at P. 20; Al-Samhan, *supra* note 1687, at 74.
[1699] *See Id*.
[1700] For more information about the regulations regarding authorized persons, please *see* Authorized Persons Regulations, Board of the Capital Market Authority's Resolution No. 1-83-2005, Dated 21/05/1426H (corresponding to June 28, 2005), Amended by Resolution No. 3-85-2017, Dated 27/12/1438H (corresponding to Sep 18, 2017), https://cma.org.sa/en/RulesRegulations/Regulations/Documents/AUTHORISED%20PERSON.pdf. *See* also Mahayni, *supra* note 160, at 176.

security related to inside information "while another department of the authorised person is in possession of inside information."[1701] To claim the availability of this defense, authorized persons must meet the following conditions: (1) the authorized person has established "Chinese wall" arrangements[1702] and effectively applied and maintained these arrangements in proportion to the nature and size of the authorized person's securities business; and (2) the individual making the deal or advising the activity neither has knowledge of inside information nor has obtained "advice on the dealing or advising activity from an individual who has knowledge of the inside information." [1703]

Is It an Admissible Defense to Claim Non-use of Inside Information after Admitting Awareness?

The defense of non-use of obtained inside information can arise after it is proven that the defendant was aware of inside information and presumed that the trading or disclosure was for exploitation of such information. In this scenario, the defendant may argue that he/she was going to trade anyway and obtaining inside information was not the motivation of his/her trading activity, but he/she had other legal reasons to trade (e.g., a previous plan to pay for a financial obligation or liquidation and reinvestment, or based on a noticeable increase of stock market prices in general). This issue has been discussed by the ACRSD and CMA. However, the motivation is excluded from the assessment of the satisfaction of the moral element, which only requires general criminal intent toward the

[1701] Authorized Persons Regulations, *supra* note 1700, art. 30(c).
[1702] Article (30)(a) of the Authorised Persons Regulations defines "Chinese Wall Arrangements" as "written policies and procedures established by an authorised person to secure confidential or inside information obtained by authorised person in the course of carrying on securities business that are designed to ensure that the information is known only to employees of the authroised person who are authrorised to receive it, and to ensure that the information is not disclosed to any other persons." *Id*.
[1703] Authorised Persons Regulations, *supra* note 1700, art. 30(c) (1), (2), and (3).

elements of the prohibited conduct. Thus, this defense has been rejected by the ACRSD and CMA.[1704] At the same, they did not close the door for a future argument that could be more persuasive regarding the legitimacy of the reason to trade as a legal defense.

One case involved an allegation against a company director who traded while he was aware of inside information regarding a potential decision by the board of director to conduct a feasibility study of a merger.[1705] The defendant's attorney unsuccessfully argued that the prohibited trading conduct under Article (50)(a) was the trades based on inside information for the purpose of protecting trading activities made in good faith and was not based on inside information.[1706] The attorney argued that his client's purchase of the company's stock was not based on inside information but was based on his analysis of the stock price movement and the noticeable increase of the market price of the stock.[1707] The attorney claimed that his client had long been aware of the request to convert the affiliated companies into one joint stock company or merge them into the parent company. However, his trading pattern for the sale of his ownership resulted in the sale of 2 million shares, which proved that his client did not make his purchase of 249,803 shares before the announcement based on this inside information.[1708]

The CMA rejected the attorney's argument and asserted that while the defendant was aware of inside information, the defendant's trading was, by itself and without more, a violation of Article (50)(a) of the CML. This Article prohibits a person obtaining inside information from trading directly or indirectly on the security related to the information.[1709]

[1704] *See* ACRSD, Decision No.229/ L.S/ 2010 of 1431 H, *supra* note 1404, at P. 5.
[1705]ACRSD, Decision No.147/ L.S/ 2009 of 1430 H, *supra* note 1456, at P. 1.
[1706] *Id*. at P. 5.
[1707] *Id*.
[1708] *Id*. at P. 6.
[1709] *Id*. at P. 7.

The CMA rebutted the attorney's claim of non-use of inside information by referring to the elements required to find an insider liable under Article (50)(a). The CMA emphasized that someone who trades while he is aware of inside information obtained because of his/her special position satisfies all the elements required under Article (50)(a).[1710] This is because "the knowledge of inside information provide the one who possesses it a greater advantage that would enable him to be close to an accurate assessment of the market value of the stock."[1711] However, while rejecting that the motivation of trade is relevant to satisfy the moral element, the CMA stated that: "If we found during the investigations that the motive of the purchase of company's shares was not based on the inside information, this accusation would have been set aside. On the contrary, the investigations revealed that the inside information was the motive of the purchase of the shares."[1712]

The ACRSD rejected the defendant's defense that the obtained inside information was not the motive of the trade but the increase of the market price of the stock. The ACRSD stated that the market price of the stock was higher in previous periods, but the defendant did not purchase the stock in these periods.[1713] In addition, the ACRSD asserted that this defense should be ignored because of the inability of the defendant to reasonably justify his purchase of the stock in question.[1714]

In another case, a company's insider sold a large number of his stock holdings before the announcement of crediting unexpected expenses to the fourth quarter financial

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1710 *Id*.
1711 *Id*.
1712 *Id*.
1713 *Id*. at 21.
1714 *Id*.

results.[1715] The defendant's attorney alleged that the motivation of the trading activity was to have liquidity to pay off debt.[1716] However, the ACRSD rejected this argument and stated that this defense was not an acceptable reason or a legal justification for trading during a lock-up period. The validity and integrity of the motive to trade did not negate the offense as long as the moral element of the offense was satisfied. In addition. the ACRSD noted that the reason was not justified since the value of the shares sold exceeded the amount of the alleged debt, which demonstrated that the motive was not to pay the debt.[1717]

Summary

This part describes the regulations related to illegal corporate insider trading in Saudi Arabia by answering three questions: (1) Who is subject to the prohibition? (2) What does inside information mean? and (3) What is the requisite state of minds to find liability?

This part shows that the theory that the Saudi Arabian regulators used to regulate the subject of trading on inside information is equal access to information. That said, the prohibition reach goes beyond traditional corporate insiders to include persons having the status of insiders if they obtain inside information through a family, business, and contractual relationship. The prohibition also includes corporate outsiders who trade on inside information when they have knowledge that the information is inside information. In addition to prohibiting trading on inside information, Saudi regulations prohibit insiders from disclosing inside information to outsiders before public disclosure. They also prohibit outsiders from disclosing inside information obtained from insiders to others. Inside information is information that which is not public, related to a traded security, and its

[1715]ACRSD, Decision No.229/ L.S/ 2010 of 1431H, *supra* note 1404, at P.1
[1716] *Id*. at 3.
[1717] *Id*. at 5.

disclosure or availability to the public would significantly affect the price or value of the related security.

This part reveals some uncertainty regarding the application of the regulations on certain aspects where the distinction between legal and illegal trading becomes difficult to ascertain. In particular, there is no clear answer about whether insiders' unlawful disclosure of inside information requires positive knowledge that the disclosure will result in helping another person's trade on such information. It is also uncertain whether legitimate reasons for trade would foreclose corporate insiders from liability if they traded at a time they were aware of inside information. In addition, this part reveals that there is a contradiction in liability standards regarding outsiders' trading on inside information between the statute and CMA's regulations. CMA's regulation does not require that that the outsider must know that the inside information was received from an insider. In contrast, the statute does require this element.

Once a person violates the prohibition of trading on inside information, he/she is subject to various sanctions and penalties. The next part discusses governmental enforcement of the prohibition of illegal corporate insider trading.

Part 4. Governmental Enforcement of the Illegal Corporate Insider Trading Prohibition

Overview

The Saudi Arabian regulators have viewed the act of illegal corporate insider trading by statutory insiders and others as a serious threat to the safety and honesty of the capital market of Saudi Arabia. The CML and its implementing regulations have been designed to address such abusive market conduct by providing general prohibition of trading on inside information upon statutory insiders and others obtaining such information improperly. As a result, illegal corporate insider trading has been deterred and discouraged by categorizing it as criminal conduct punishable by the highest severe sanctions that the CML applies for securities violations. The regulators also have taken into consideration the difficulty of proving illegal corporate insider trading violations and the nature of how these violations occur. Thus, the CML has allowed the prosecution to prove the perpetration of illegal corporate insider trading using all types of evidence, whether it is direct or circumstantial.

This part discusses the elements of illegal corporate insider trading liability and the evidence needed to prove the satisfaction of these elements. This part also examines the sanctions that may be applied and imposed against illegal corporate insider trading wrongdoers.

Elements of Illegal Corporate Insider Trading Liability

To prove that a person, who is subject to the prohibition scope of illegal corporate insider trading, is liable for violating Article (50) of the CML and Articles (4), (5), or (6) of the MCR, there must be a satisfaction of elements required under these articles. Article (50)(a) of the CML states that an insider is prohibited from directly or indirectly trading in a security related to inside information when the insider knows that such information is not generally available and, if it were available, it would have a material effect on the price or value of such security.[1718] It also prohibits an insider from disclosing such information to another person with the expectation that such person will trade in the related security.[1719]Article (6)(a) and (5)(a) of the MCR provide the same prohibition. Article (6)(a) states that: "an insider is prohibited from engaging in insider trading."[1720]Article (5)(a) prohibits insiders "from disclosing any inside information to any other person."[1721]

In addition to prohibiting insiders from engaging in illegal corporate insider trading and improper disclosure conduct, Article (50)(b) imposes prohibition upon outsiders as follows: "No person may purchase or sell a security based on information obtained from an insider while knowing that such person, by disclosing such insider information related to the security," and if so, they have violated their duty not to disclose under Article (50)(a).[1722] The prohibition is defined under Article (6)(b) and (5)(b) of the MCR. Article (6)(b) provides that an outsider is prohibited from engaging in illegal corporate insider trading if he/she obtains inside information from another person and knows or should know that the information is inside information.[1723] Article (5)(b) of the MCR states that an outsider is prohibited from disclosing inside information he/she has obtained from an insider.[1724]

[1718] CML, *supra* note 152, art. 50(a).
[1719] *Id*.
[1720] MCR, *supra* note 156, art. 6(a).
[1721] *Id*. art. 5(a).
[1722] CML, *supra* note 152, art. 50(b).
[1723] MCR, *supra* note 156, art. 6(b).
[1724] *Id*. art. 5(b).

On the basis of this preview of these articles, the elements of liability for illegal corporate insider trading can be divided into two types depending on the determination of whether the accused person is a statutory insider or an outsider.

Statutory Insiders' Elements of Liability

If the accused person is a statutory insider, three elements are required to find the insider liable for violating Article (50)(a) of the CML and Articles (6)(a) and (5)(a) of the MCR. The first element, the "assumed element," requires determining that the accused insider has special status. The second element, the "material element," covers the *actus reus* of the prohibited illegal corporate insider trading conduct. The third element, the "moral element," relates to the *mens rea* of the accused person while committing the prohibited conduct. These elements are discussed below.

Assumed Element

The assumed element is a condition in Article (50)(a) of the CML requiring the availability of specific types of relationships from which inside information is obtained. Article (50)(a) states that: "Any person who obtains, through family, business or contractual relationship, inside information."[1725] As Article (4)(b) of the MCR illustrates, this includes traditional insiders, such as directors and senior executives, as well as others who obtain inside information in confidence because of family, business, or contractual relationships.[1726] The notion of the assumed element is that it is always presumed that these statutory insiders are privy to inside information. Therefore, their trading is presumed to be based on inside information without the need to demonstrate access to such

[1725] CML, *supra* note 152, art. 50(a).
[1726] MCR, *supra* note 156, art. 4(b).

information.[1727] As a result, when the defendant has a statutory insider position, this element is satisfied.[1728]

Material Element

The material element means the performance of physical acts of the prohibited conduct subject to illegal corporate insider trading liability.[1729] The prohibited conduct of illegal corporate insider trading involves trading in a security related to the inside information either directly or indirectly or the disclosure of inside information to outsiders to trade.[1730]

a. Direct or Indirect Trade of a Security Related to Inside Information

The main prohibited conduct under illegal corporate insider trading liability is the exploitation of inside information obtained by an insider because of his/her position inside the company. The performance of physical conduct is represented in the purchase or sale of the security related to inside information while the information has not been publicly disclosed.[1731] To satisfy the material element, three factors must be present: (1) physical conduct by either entering into a purchase or sale of a security related to inside information or disclosing such information; (2) the information has not yet been released to the public; and (3) it meets the statutory requirements of inside information.[1732] However, it is irrelevant whether or not the trader has experienced the result from the purchase or sale and regardless of whether the purchase or sale has been made directly or indirectly.[1733]

[1727] *See* ACRSD, Decision No.973/ L.S/ 2015 of 1437 H, *supra* note 1452, P. 14.
[1728] *See* ACRSD, Decision No.147/ L.S/ 2009 of 1430 H, *supra* note 1456, at P.12.
[1729] Al-Nufi, *supra* note 1454, at 181.
[1730] CML, *supra* note 50(a).
[1731] Farghaly, *supra* note 1474, at 28.
[1732] *See* ACRSD, Decision No.147/ L.S/ 2009 of 1430 H, *supra* note 1456, at P.13; 20; ACRSD, Decision No.148/ L.S/ 2009 of 1430 H, *supra* note 1501, at P. 9, 20.
[1733] *Id*.

Article (4)(a) of the MCR defines when trading of a security is made directly or indirectly as follows: (1) the purchase or sale is direct if the insider "executes a trade in the security for any account in which he has an interest;[1734] or (2) if he makes a bid or offer on the Exchange for the security."[1735] The purchase or sale is made indirectly when: (1) the insider "executes a trade as an agent for another person; (2) if he arranges a trade to which a relative or person with whom he has a business or a contractual relationship is a party; (3) if he arranges for his agent or any other person acting on his behalf or at his direction to trade in the relative securities."[1736] The meaning of indirect trading on inside information is that the insider is not the one making the trade, but rather another person has been used as a tool to cover the real identity of the trader (i.e., the insider).[1737]

b. Disclosure of Inside Information to Another Person to Trade Directly or Indirectly

The disclosure of inside information to another person for trading purposes is prohibited under Article (50)(a) of the CML and Article (5)(a) of the MCR. This prohibition constitutes an insider performing a specific action of disclosure or transfer of inside information to another person, and the recipient's exploitation of the information by trading in the security related to this information either directly or indirectly.[1738] However, it is important to mention that even if the recipient of the information did not trade directly

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[1734] *See* ROSCO, *supra* note 204, art. 68(c): (A person is deemed to have an interest in shares or convertible debt instruments of an issuer when such securities are owned or controlled by: "1) a relative of that person; 2) a company controlled by that person; or 3) any other person with that person has agreed to act in concert to acquire an interest in or exercise voting rights in the shares or in the convertible debt instruments of the issuer.") *Id*.
[1735] MCR, *supra* note 156, art. 4(a)(3).
[1736] *Id*. art. 4(a)(4).
[1737] Farghaly, *supra* note 1474, at 28.
[1738] *See* ACRSD, Decision No.148/ L.S/ 2009 of 1430 H, *supra* note 1501, at P. 20.

or indirectly in the related security, the disclosing insider may still be liable under Article (5)(a) of the MCR.[1739]

Moral Element

The moral element is about the *mens rea* or the requisite culpable state of mind of the defendant at the time of the prohibited conduct. To satisfy this element, it requires that the insider had general criminal intent at the time of the trade. The insider must know that he/she is in possession of inside information and he/she intends to take advantage of possessing the information before it becomes public, by trading directly or indirectly in the security related to the inside information or disclosing it to another to trade.[1740] The motivation of the trade is irrelevant to prove the moral element. Even if the information is not the motive of the trade, such trade is in violation of the regulations of illegal corporate insider trading.[1741] To satisfy the moral element for the disclosure of inside information, the disclosing insider must disclose the inside information to another person while he knows that he has inside information that has not been announced to the public.[1742]

Outsider's Elements of Liability

There are two elements of liability for outsiders' violations of illegal corporate insider trading regulations: the material element and the moral element.[1743] The material element of outsiders' liability resembles the same prohibited conduct as insiders. They are prohibited from either trading in the security related to obtained inside information or

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[1739] *See supra* notes 1530-47 and accompanying text. *See* also Farghaly, *supra* note 1474, at 31; Al-Nufi, *supra* note 1454, at 181.
[1740] *See* Farghaly*, supra* note *1474*, at 38; Al-Nufi, *supra* note 1454, at 186; ACRSD, Decision No.148/ L.S/ 2009 of 1430 H, *supra* note 1501, at P. 19-20. *See Supra* notes 1683-99 and accompanying text.
[1741] *See Supra* notes 1704-17 and accompanying text. *See* also ACRSD, Decision No.147/ L.S/ 2009 of 1430 H, *supra* note 1456, P. 7.
[1742] *See* ACRSD, Decision No.148/ L.S/ 2009 of 1430 H, *supra* note 1501, P. 20.
[1743] ACRSD, Decision No.146/ 2009 /ل.س of 1430H, *supra* note 1457, at P. 8.

disclosing the information to others.[1744] However, since outsiders are not presumed by law to be privy to inside information, their liability is based on trading on obtained inside information from others who are privy to inside information.[1745] Although Article (50)(b) clearly states that "no person may purchase or sell a Security based on information obtained form an insider,"[1746] The CMA interpreted this rule in Article (6)(b) of the MCR as "A person who is not insider is prohibited from engaging in insider trading if he obtains the inside information from another person…"[1747] Therefore, the CMA reads Article (50)(b) as not requiring that an outsider must obtain the information from an insider or even know the identity of the disclosing person. [1748]

The moral element of outsiders' liability is established based on the same requisite state of mind that is required for insiders' liability. The outsider must be aware that the obtained information is inside information based on the statutory requirements and he/she intends to use the information through the purchase or sale of a security related to the inside information or the disclosure to others to trade while the information is non-public.[1749]

Evidence in Illegal Corporate Insider Trading Proceedings

[1744] *Id*.
[1745] *Id*.
[1746] CML, *supra* note 152, art. 50(b).
[1747] MCR, *supra* note 156, art. 6(b).
[1748] *See* ACRSD, Decision No.146/ 2009 /ل.س of 1430H, *supra* note 1457, at P. 8. However, some commentators have argued that Article (6)(b) goes beyond what Article (50)(b) expressly states that the outsider must obtain the inside information form an insider. *See* Al-Nufi, *supra* note 1454, at 186. This understanding was adopted by the ACRSD in one published case. *See* ACRSD, Decision No.146/ 2009 /ل.س of 1430H, *supra* note 1457, at P. 19. However, in another published case, the ACRSD reviewed this issue but did not provide an express statement of whether the source of the information must be an insider or not. That said, it can be inferred that the ACRSD has adopted the CMA's position that the source of information is irrelevant to the elements of liability for outsiders' violations. *See* ACRSD, Decision No.974/ L.S/ 2015 of 1437 H, *supra* note 1453, at P. 13.
[1749] *See* ACRSD, Decision No.146/ 2009 /ل.س of 1430H, *supra* note 1457, at P. 8, 19; ACRSD, Decision No.974/ L.S/ 2015 of 1437 H, *supra* note 1453, at P. 2, 13. *See* also Farghaly, *supra* note *1474*, at 51; Al-Nufi, *supra* note 1454, at 186.

Article (25)(i) of the CML has clearly established a broad rule evidentiary standard stating that: "Evidence in Securities cases shall be admissible in all forms including electronic or computer data, telephone recordings, facsimile messages and electronic mail."[1750] As a result, the Saudi Arabian regulators have adopted the standard of a "free proving method" in illegal corporate insider trading proceedings and other securities cases where liability can be demonstrated by unmitigated evidence. There is no differentiation between the civil and criminal evidentiary standard and both proceedings can be proved by direct or circumstantial evidence.[1751] One of the reasons behind adopting this broad evidentiary standard is that the regulators took into consideration the special nature of illegal corporate insider trading offense and securities violations where, in most instances, direct evidence is unavailable.[1752]

The ACRSD and CMA have asserted that the principle of flexible standard or proof is a well-established principle in Saudi Arabian criminal law, and it is more important in the area of securities violations.[1753] This is because securities crimes are easily committed and do not leave any significant material evidence that may point to the violator or the circumstances of the perpetration of the crime. In addition, the negative effect of such crimes on the safety and honesty of the capital market and investors' confidence in the integrity of securities transactions necessitates the expansion of acceptable evidence to prove securities crimes and violations.[1754]

[1750] CML, *supra* note 152, art. (25)(i).
[1751] *See* Farghaly*, supra* note *1474*, at 53; Tariq Afifi Sadiq, *Al-Himaya Al-Qanunia Li'amaliat Altadawul Fi'aswaq Almal Wifqun Li'nidhaam Al-Sauodi* [Legal Protection for Trading Transactions in the Capital Markets According to the Saudi Law], 288, (2015). (Ar).
[1752] *See Id*.
[1753] ACRSD, Decision No.974/ L.S/ 2015 of 1437 H, *supra* note 1453, at P. 18.
[1754] *Id*. *See* also ACRSD, Decision No.973/ L.S/ 2015 of 1437 H, *supra* note 1452, P. 14.

Article (25) (i) of the CML has applied the flexible standard of proof on both civil and criminal lability and has expressly ascertained the validity of electronic and non-traditional evidence. On the basis of this Article, illegal corporate insider trading liability can be proven by direct evidence including a legal confession by the defendant, witness testimony, and documentary evidence, which directly demonstrate the commission of illegal corporate insider trading.[1755] However, the express validity or authentication of electronic and non-traditional evidence, under Article (25)(i) of the CML, highlights the importance of this type of evidence in securities cases since securities violations are usually proven through such evidence.[1756] The essential evidence in illegal corporate insider trading cases is the electronic report prepared by the CMA's Department of Surveillance and Analysis. The CMA has used an electronic surveillance system to monitor the daily securities transactions.[1757] If an illegal trading transaction is suspected, a surveillance inquiry is released. The department then studies and analyzes the data of the trade in question, and if it reveals that the transaction may be in violation of the law, the case is transferred with a report to the Enforcement Department for appropriate action.[1758] In addition to surveillance reports, recorded telephone conversations have been useful evidence to demonstrate the illegal corporate insider trading claim. The CMA's Authorised Persons Regulations, Article (51), requires authorized persons, including brokers and dealers, to record telephone communication made with their clients.[1759] Moreover, this

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[1755] *See* Farghaly*, supra* note *1474*, at 53; Sadiq, *supra* note 1751, at 288.
[1756] *Id*.
[1757] *See Annual Report 2017*, *supra* note 1438, at 151.
[1758] *Id*. *See* also Capital Market Authority, *Organizational Structure*, https://cma.org.sa/en/AboutCMA/CMA_Department/Pages/default.aspx.
[1759] Authorised Persons Regulations, *supra* note 1700, art. 51(a). *See* Sadiq, *supra* note 1751, at 288.

article requires authorized persons to disclose to their clients that the telephone conversations will be recorded.[1760] These telephone recordings have been used by CMA to review the conversations of potential accused persons and their brokers/dealers to determine whether the recordings involved any mention of the nature and source of information obtained and the trading motivation.[1761]

Illegal corporate insider trading liability can also be proven by circumstantial evidence that does not directly prove the event in question, but indirectly show other events that could reasonably infer the occurrence of the prohibited conduct.[1762] Circumstantial evidence used in illegal corporate insider trading proceedings includes statutory circumstantial evidence, such as the law presumes the knowledge of the law.[1763] In addition to statutory circumstantial evidence, there is judicial circumstantial evidence where the judges analyze the facts of the case and the surrounding circumstances. They then derive the circumstantial evidence from the facts presented and use it to prove or disapprove the culpable event.[1764] The most common types of circumstantial evidence used by the ACRSD and CMA to prove the liability of trading on inside information are as follows: (1) whether there is a relationship that may connect the defendant to an insider; (2) suspicious trading timing with high volume and number of shares preceding an issuer's public disclosure; (3)

[1760] *Id*. art. 51(b).

[1761] *See Id*. art. 51(c); Sadiq, *supra* note 1751, at 295. In one case, the ACRSD found two defendants liable for trading on inside information where the evidence presented inferred that the first defendant obtained inside information from an insider. ACRSD, Decision No.146/ 2009 /ل.س of 1430H, *supra* note 1457. At P. 21. The ACRSD relied on convicting the two defendants on a recorded telephone conversation between the first defendant and his broker. The first defendant told the broker that he received inside information from the board of director that they would not announce that the company was raising capital; therefore, he asked the broker to sell his stock holdings in this company. *Id*.

[1762] Farghaly, *supra* note *1474*, at 61. *See* Amir Ali Al-Qaradaghi, *Masayil Fiqhia Muasira* [Contemporary Jurisprudential Issues] 36, (2011), http://irep.iium.edu.my/5693/1/مسائل_فقهية_معاصرة.pdf. (Ar).

[1763] *See* ACRSD, Decision No.229/ L.S/ 2010 of 1431H, *supra* note 1404, at P. 5.

[1764] Farghaly, *supra* note *1474*, at 61; Al-Qaradaghi, *supra* note 1762, at 38.

the defendant's trading history of the stock during the previous six months; and (4) whether the defendant could reasonably justify his/her trading during the suspicious time.[1765]

The direct or circumstantial evidence presented must persuade the magistrates of two aspects. The first aspect is that the evidence presented must show that the trading event occurred and violated the law. The second aspect must demonstrate the attribution of the perpetration of the violation to the defendant in question and that he/she was subject to punishment.[1766] Therefore, the judges must make their conclusion based on the presented evidence and whether or not it was enough to find the defendant liable for committing an illegal corporate insider trading violation.[1767] The ACRSD stated that it is not required to base its judgment on evidence that positively proves all parts of the alleged facts.[1768] It is sufficient that all pieces of presented evidence, as a group, constitute the Committee's satisfaction of its conclusion of the case.[1769] The ACRSD also emphasized that it is fully empowered to comprehend the facts and to assess the presented evidence and to conclude what it deems appropriate to be applied based on the alleged facts.[1770] The ACRSD asserted that while the committee exercises its assessment, it has full discretionary power to uphold what it deems to be persuading evidence and to ignore other evidence, even if it is probable in the case.[1771]

Sanctions and Penalties of Illegal Corporate Insider Trading Violations

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[1765] *See* ACRSD, Decision No.973/ L.S/ 2015 of 1437 H, *supra* note 1452, P. 20; ACRSD, Decision No.974/ L.S/ 2015 of 1437 H, *supra* note 1453, at P. 16.
[1766] Farghaly, *supra* note *1474*, at 54; Al-Qaradaghi, *supra* note 1762, at 49.
[1767] *See* ACRSD, Decision No.148/ L.S/ 2009 of 1430 H, *supra* note 1501, P.20.
[1768] *See* ACRSD, Decision No.974/ L.S/ 2015 of 1437 H, *supra* note 1453, at P. 17; ACRSD, Decision No.973/ L.S/ 2015 of 1437 H, *supra* note 1452, P. 27.
[1769] *Id*.
[1770] ACRSD, Decision No.147/ L.S/ 2009 of 1430 H, *supra* note 1456, at P.21; ACRSD, Decision No.148/ L.S/ 2009 of 1430 H, *supra* note 1501, P. 21.
[1771] *Id*.

Illegal corporate insider trading violations are treated as criminal acts by the CML. The law has imposed several severe sanctions and penalties against violators, including imprisonment up to five years. By adopting a full disclosure policy, the imposition of such severe sanctions and penalties reveals the seriousness of the violations and shows how the CML intends to apply tough deterrence measures for a breach of insiders' duty of trust and confidence. When they misuse non-public information, they disrupt the available public information and damage investors' confidence by trading or disclosing inside information to others to trade.[1772]

The imposition of sanctions and liability is the last step of an illegal corporate insider trading proceeding after a series of procedures and steps. It starts with the suspicion of an illegal corporate insider trading violation, an investigation and collection of evidence, filing a case before the CRSD, a trial hearing and presenting arguments, and then ends with a judgment by the CRSD that may include sanctions and penalties if convicted.

Investigation Power and Public Prosecution

The CML has empowered the Board of CMA, under Article (5)(c), to conduct the necessary investigations to enforce the CML and its implementing regulations.[1773] The CMA has the right to undertake appropriate investigative procedures regarding any potential violations of the law including the right to subpoena witnesses, collect evidence,

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[1772] *See* ACRSD, Decision No.229/ L.S/ 2010 of 1431H, *supra* note 1404, at P. 3.
[1773] CML, *supra* note 152, art. 5(c). (This Paragraph states that: "For the purpose of conducting all investigations which, in the opinion of the Board, are necessary for the enforcement of the provisions of this Law and other regulations and rules issued pursuant to this Law, the members of the Authority and its employees designated by the Board are empowered to subpoena witnesses, take evidence, and require the production of any books, papers, or other documents which the Authority deems relevant or material to its investigation. The Authority shall have the power to carry out inspections of the records or any other materials, whoever the holder may be, to determine whether the person concerned has violated, or is about to violate any provision of this Law, the Implementing Regulations or the rules issued by the Authority.") *Id*.

and require the production of any documents related to the investigation.[1774] In addition, the CMA was authorized to conduct any public action against the accused persons before the CRSD.[1775] However, on December 31, 2014 and pursuant to the High Order of the Prime Minister of the Council of Ministers of Saudi Arabia,[1776] the CMA transferred the authority of investigation and public prosecution of violations to the Public Prosecution under Articles (31), (49) and (50) of the CML.[1777] Transferring investigation and prosecution powers to the Public Prosecution has resulted in decreased authority for the CMA so they now only have the right to refer any suspected violations to the Public Prosecution under Article (50) of the CML.[1778]

If the investigation results in a decision to charge the accused person, public action is taken by the Public Prosecution by filing a public lawsuit before the CRSD in accordance with the Resolution of Securities Disputes Proceedings Regulations of 2011.[1779]

Jurisdiction of the CRSD over Securities Disputes and Imposition of Sanctions

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[1774] *Id*. *See* Al-Nufi, *supra* note 1454, at 420; *Beach, supra* note *153*, at 325, 50.
[1775] CML, *supra* note 152, art. 59(a). *See Id*.
[1776] High Order No. (4690), Dated 6/2/1435 (corresponding to Dec 10, 2013), *see* Capital Market Authority, CMA Announces the Start of the Referral of Criminal Offences to the Bureau of Investigation and Public Prosecution (Dec 31, 2014), *available at*: https://www.cma.org.sa/en/market/news/pages/cma_n_1589.aspx.
[1777] *Id*.
[1778] The CMA has indicated that since the High Order date, it has referred to the Public Prosecution 88 cases related to violations of Article (31), (49) and (50) of the CML by the end of 2017. *Annual Report* 2017, *supra* note 1438, at 162. *See* also Capital Market Authority, Conclusion of Joint Workshop Between CMA & the Branch of the Bureau of Investigation & Public Prosecution in Riyadh, (April 1, 2017), available at https://cma.org.sa/en/MediaCenter/PR/Pages/BBIPPWorskshop.aspx.
[1779] The regulations of criminal and civil proceedings before the CRSD and ACRSD are promulgated by the Board of CMA, pursuant to Article (25)(d) of the CML, under the Resolution of Securities Disputes Proceedings Regulations (RSDPR), Resolution No. 1-4-2011, Dated 19/2/1432H (corresponding to Jan 23, 2011), Amended by Resolution No. 1-104-2017, Dated 2/3/1439H (corresponding to Nov 20, 2017), available at: https://cma.org.sa/en/RulesRegulations/Regulations/Documents/RSDPR_en.pdf.

One of the features of the CML is that it has created special judicial bodies, the CRSD and ACRSD, which are empowered to exclusively adjudicate securities cases.[1780] In addition, the CML only allows filing lawsuits in designated judicial committees against investors or related securities regulatory bodies in Saudi Arabia.[1781]

The CML has given the CRSD and ACRSD the necessary powers to exercise their judicial jurisdiction on securities disputes.[1782] These judicial powers include the issuance of subpoenas, orders to produce evidence, and to settle disputes and impose sanctions.[1783] In illegal corporate insider trading and other criminal cases, this judicial power is triggered after the CMA or Public Prosecution seeks such imposition of sanctions and penalties.[1784] The ACRSD has asserted that the imposition of appropriate sanctions and penalties upon violators is part of exercising its jurisdiction over settling securities disputes.[1785] The ACRSD has stated that the imposition of appropriate sanctions and penalties is under the discretion of the committee. These sanctions and penalties are applied based on serving and achieving the goals of the law, which include the policy of full disclosure and transparency in the capital market and to ensure the protection of investors from unfair and

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[1780] *See* CML, *supra* note 152, art. 25(a). (This Article reads: "The Authority shall establish a committee known as the 'Committee for the Resolution of Securities Disputes' which shall have jurisdiction over the disputes falling under the provisions of this Law, its Implementing Regulations, and the regulations, rules and instructions issued by the Authority and the Exchange, with respect to the public and private actions.") *Id*. *See* also art. 25 (g). (This Article states that "An Appeal Panel is to be formed by a Council of Ministers' decision…The Appeal Panel shall have the discretion to refuse to review the decisions of the Committee for the Resolution of Securities Disputes, to affirm such decisions, to undertake a *de novo* review of the complaint or suit based on the record developed at the hearing before the Committee and to issue such decision as it deems appropriate in relation to the complaint or the suit. The decisions of the Appeal Panel shall be final.") *Id*.

[1781] *See Beach, supra* note *153*, at 347, 52; *Gouda, supra* note *161*, at 119.

[1782] *See* CML, *supra* note 152, art. 25(a) to (i). *See* Sadiq, *supra* note 1751, at 270

[1783] *See* CML, *supra* note 152, art. 25(a). *See* the Resolution of Securities Disputes Proceedings Regulations, *supra* note 371.

[1784] *See* CML, Art. (59)(a). *See* also Al-Nufi, *supra* note 1454, at 420; *Beach, supra* note *153*, at 350.

[1785] ACRSD, Decision No.148/ L.S/ 2009 of 1430 H, *supra* note 1501, P. 22.

improper conduct. Thus, the Committee has the power to consider the mitigating and aggravating circumstances of sanctions when contemplating the facts and surrounding circumstances.[1786]

<u>Available Sanctions and Penalties against Illegal Insider Trading Wrongdoers</u>

The available sanctions and penalties against violators of illegal corporate insider trading prohibition include administrative actions, civil liability, and criminal sanctions.

<u>Administrative Actions</u>

The CML has given the CMA vast power to tackle illegal corporate insider trading violations and to enforce the CML sanctions and penalties. They are designed to ensure that wrongdoers are punished for gaining unjustified free-risk profits or avoiding losses by trading on inside information that must not be used until it reaches the public domain. The CMA has three main powers that can be invoked against illegal corporate insider trading violations: to trigger an illegal corporate insider trading case, to financially punish wrongdoers without the need to file a case with the CRSD, or to settle with the accused person.

a. Triggering Illegal Insider Trading Violation Cases

Since the CMA is responsible for monitoring the securities trading activities, suspicious trading transactions involving illegal corporate insider trading are discovered first by the CMA's department of surveillance and analysis through the use of an electronic surveillance system.[1787] Therefore, a report that the Department of Surveillance and Snalysis issues triggers an illegal corporate insider trading case. Based on this report, the

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[1786] *Id*.

[1787] *See* CML, *supra* note 152, art. 5; *Annual Report* 2007, *supra* note 1434, at 57; *Annual Report* 2017, *supra* note 1438, at 162.

Board of the CMA decides whether to transfer the suspected violation to the Public Prosecution or save the case.[1788] As a result, the first administrative action that the CMA has is the right to trigger an investigation of a potential illegal corporate insider trading violation. Then it can refer the violation to the Public Prosecution to start an official investigation, which may lead to filing a public action case with the CRSD to seek judicial sanctions and penalties pursuant to Articles (57)(c) and (59)(a) of the CML.[1789]

b. Imposition of Financial Penalties on Illegal Insider Trading Wrongdoers Without Filing a Case with the CRSD

Article (59)(b) of the CML grants the Board of the CMA the right to impose a fine against any violators of the CML and its implementing regulations.[1790] Imposition of this violation must not be granted until the investigation is closed and results in finding that the conduct of the accused person is in violation of the prohibition of illegal corporate insider trading.[1791] The Board of CMA has the right to impose a fine not less than SR10,000 ($2,666) and not more than SR100,000 ($26,666) for each violation attributed to the

[1788] The CMA indicated that from the date of the High Order that decided to transfer the investigation and prosecution power to the Public Prosecution, it has referred 88 cases to the Public Prosecution related to violations of Article (31), (49) and (50) of the CML by the end of 2017. *Annual Report* 2017, *supra* note 1438, at 162.
[1789] *See* CML, *supra* note 152, art. 59(a).
[1790] CML, *supra* note, 2, art. 59(b). (This article reads: "The Authority may, in addition to taking the actions provided for under paragraph (a) of this Article, request the Committee to impose a financial fine upon the persons responsible for an intentional violation of the provisions of this Law, its Implementing Regulations, the rules of the Authority and the regulations of the Exchange. As an alternative to the foregoing, the Board may impose a financial fine upon any person responsible for the violation of this Law, its Implementing Regulations, the rules of the Authority and the regulations of the Exchange. The fine that the Committee or the Board can impose shall not be less than SR 10,000 and shall not exceed SR 100,000 for each violation committed by the defendant.") *Id*.
[1791] Al-Nufi, *supra* note 1454, at 443; *Beach, supra* note *153*, at 350-51.

accused person.[1792] It is important to mention that Article (59)(b) clearly states that the fine is imposed for each violation individually as it constitutes a separate violation by itself.[1793] Therefore, violations are not correlated even though there is only one criminal result. For example, when an insider trades several times on the same inside information, the fine may be imposed for each trading time.[1794]

c. Authority to Settle with the Accused Person before Filing a Case before the CRSD

Article (64) of the CML provides that it is admissible for the CMA and an accused person to reach a settlement to avoid proceedings before the CRSD.[1795] This article grants the CMA the right to settle after an investigation results in accusing the person,[1796] but the offer to settle cannot be rendered until there is an actual indictment against such a person.[1797] The authority to settle with the accused person for violating the law is a unique authority given to the CMA when it discerns that the suitable and appropriate way to punish the accused person is to make him/her pay triple the profits or losses avoided from

[1792] CML, *supra* note 152, art. 50(b).
[1793] *Id*. *see* Al-Nufi, *supra* note 1454, at 444.
[1794] *See* ACRSD, Decision No.229/ L.S/ 2010 of 1431H, *supra* note 1404, at P. 3.
[1795] CML, *supra* note 152, art. 64. (This Article reads: "A person charged with violation of Article 50 of this Law may avoid proceedings before the Committee by reaching an agreement with the Authority pursuant to which he agrees to pay the Authority a sum not exceeding three times the profit he has realized, or three times the losses he has averted by committing the violation. Such arrangement shall be without prejudice to any compensation awardable as a result of the violation.") *Id*.
[1796] *See* Al-Nufi, *supra* note 1454, at 447; *Beach, supra* note *153*, at 349; *Gouda, supra* note *161*, at 157.
[1797] *Id*.

committing illegal corporate insider trading.[1798] The option of settlement to avoid criminal proceedings is not a right of the accused person but an exclusive right of the CMA to choose instead of criminal prosecution.[1799] In some instances, however, when an accused person tries to request a settlement during the investigation to avoid judicial proceedings, it can be used by the prosecution as circumstantial evidence against the accused person. In a case before the ACRSD, during the interrogation, the accused person requested a settlement with the CMA,[1800] but then the CMA used the accused person's settlement request as circumstantial evidence of self-admission of committing illegal corporate insider trading.[1801]

<u>Judicial Civil Liabilities and Criminal Sanctions</u>

The CML has allowed the prosecution to seek and impose broad and varied civil and criminal actions against illegal corporate insider trading wrongdoers.[1802] Such actions may be taken at an early stage, even before the trial commences. Other civil actions are also available to the CRSD and ACRSD to impose on the accused person after conviction. Article (59)(a) of the CML states that "if it appears to the Authority that any person has engaged, is engaging, or is about to engage in acts…constituting violation..., the Authority shall have the right to bring a legal action before the Committee to seek an order for the appropriate action…"[1803] This article contains several civil orders and penalties that the CRSD may decide to apply whether in the pre-trial period and as precaution measures or

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[1798] *Id*.
[1799] Al-Nufi, *supra* note 1454, at 451.
[1800] ACRSD, Decision No.974/ L.S/ 2015 of 1437 H, *supra* note 1453, at P. 3.
[1801] *Id*.
[1802] *See Gouda, supra* note *161*, at 162; *Beach, supra* note *153*, at 350.
[1803] CML, *supra* note 152, art. 59(a). The power to *see*k an order for the appropriate action against illegal insider trading wrongdoers was transferred to the Public Prosecution on Dec 31, 2014. *See supra* notes 368 and accompanying text.

to impose as civil penalties after a conviction. Article (57)(c) gives the prosecution the right to seek prison terms against the accused person.[1804]

a. Preliminary and Precaution Civil Actions

The prosecution can request that the CRSD issue a temporary order against an accused person including seizing and executing property, a travel ban, and a ban from trading.[1805] These temporary decisions can be requested even before the issuance of an indictment against the accused person when the prosecution deems it necessary to prevent the accused person from actions that may hinder the illegal corporate insider trading case. The Resolution of Securities Disputes Proceeding Regulations, Article (37), determines the procedures that must be taken by the prosecution to request a temporary order.[1806] This article allows the CRSD to issue a temporary decision against the accused person after a request by the prosecution. It expressly states three available temporary decisions: a travel ban, placing a protective attachment on the accused person's properties including bank and investment accounts, or a trading ban from any purchase in the Exchange.[1807] However, this article provides that the prosecution must justify its request of issuing a temporary order against an accused person, including legal documents and supporting proof.[1808] This article also allows the CRSD to issue a temporary order after a request from the prosecution for 30 days in the event that there were no official charges issued by the prosecution.[1809] Moreover, an accused person who is subject to a temporary order may challenge the

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[1804] *Id*. at art. 57(c).
[1805] Id. at art. 59(a)(2), (7) and (8).
[1806] RSPDR, *supra* note 371, art. 37.
[1807] *Id*.
[1808] *Id*. at art. 37(1).
[1809] *Id*. at art. 37(2).

decision by filing a memorandum with the committee requesting a cancelation of the order.[1810]

b. Civil Penalties and Criminal Sanctions

Articles (57)(c) and (59)(a) contain several available civil penalties and criminal sanctions that the prosecution can seek to impose before the CRSD. The CRSD has the discretion to impose such a sanction or reject it even if there was a conviction.

Civil penalties that can be imposed upon illegal corporate insider trading wrongdoers include the imposition of disgorgement of all gains realized or losses avoided from illegal corporate insider trading transactions.[1811] Article (59)(a)(4) provides two options for payment of penalties. It provides that the disgorgement can be paid as indemnification to persons who have suffered damages because of the violation. It also offers the option to deposit the amount of the illegal gains in CMA's account.[1812] In addition to disgorgement and restitution, the CRSD may ban the person from working for listed companies[1813] or working as a broker, portfolio manager, or investment advisor for a period determined at the discretion of the CRSD.[1814] Another civil penalty is a ban from trading (or purchasing) securities for a period determined by the CRSD.[1815]

[1810] *Id*. at art. 37(3).
[1811] CML, *supra* note 152, art. 59(a)(4).
[1812] *Id*. However, it can be noted that all available illegal insider trading cases show that the disgorgement is payed to the CMA's account.
[1813] *Id*. art 59(a)(9).
[1814] *Id*. art. 59(a)(6).
[1815] *Id*. art. 59(a)(2). It is important to mention that the CRSD has the authority to determine the specific amount of disgorgement and the duration of a ban from trading, working for a listed company or as a broker, portfolio manager or investment advisor, or other demanded penalties or sanctions. *See* ACRSD, Decision No.974/ L.S/ 2015 of 1437 H, *supra* note 1453, at P. 18. (on the basis of the published cases, the usual period applied is three years for all of these penalties.) *See Id*.

Two criminal sanctions are available to be imposed upon illegal corporate insider trading wrongdoers. The most important sanction is imprisonment terms of up to five years as provided by Article (57)(c) of the CML.[1816] The other available criminal sanction is the imposition of a financial fine against the violator, pursuant to Article (59)(b) of the CML. The fine must not be less than SR10,000 ($2,666) and not exceed SR100,000 ($26,666).[1817]

<u>Statute of Limitations</u>

Although the CML provides statutes of limitation under Article (58)[1818] for claims brought under Articles (55), (56) and (57),[1819] illegal corporate insider trading violations

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1816 CML, *supra* note 152, art. 57(c). (This article states that: "In addition to the penalties and financial compensation provided for under this law, the Committee may, based on a claim filed by the Authority, punish the persons who violate Article 49 and 50 with imprisonment term not exceeding five years."). (However, there is no clear standard of when the prosecution can *see*k imprisonment terms against the accused person. On one published case, the CMA did not request the imposition of imprisonment term against the accused person. *See* ACRSD, Decision No.147/ L.S/ 2009 of 1430 H, *supra* note 1456, at P. 22. In contrast, all the other published cases, it is noted that the CMA sought imprisonment terms against the accused person. In one case, the CMA appealed against CRSD's decision which included the rejection of imposition of imprisonment sentence against the accused person. ACRSD, Decision No.229/ L.S/ 2010 of 1431H, *supra* note 1404, at P. 3. In this case, the CMA reasoned its rejection to the CRSD's decision that the legislators have sought to protect the market from the pervasive of crimes and to achieve the principles of equal access to information among investors. For enforcing this goal, the Saudi legislators have imposed imprisonment terms against illegal insider trading wrongdoers to punish them for their unlawful act and to deter the reoccurrence of this crime in the market. *Id*. However, the ACRSD asserted that the imposition of imprisonment terms is subject to the discretion of the CRSD "which is empowered to determine the appropriate sanctions considering the conditions and the circumstances of each offense in accordance with the authority that is delegated to CRSD under Article (25/a) of the Law." Therefore, the ACRSD concluded that it was unnecessary to overturn the CRSD's decision. *Id*. at P. 6.

1817 CML, art. 59(b). *See supra* notes 1793-94 and accompanying text.

1818 CML. art. 58. (This Article states that: "A suit under Articles 55, 56 and 57 of this Law shall not be heard if the complaint is filed with the Authority after the elapse of one year from the date when the claimant should reasonably have been aware of facts causing him to believe he had been the victim of a violation, and in no case may such complaint be heard by the Committee after five years from the occurrence of the violation subject of the claim.") *Id*.

1819 CML, *supra* note 152, arts. 55, 56 and 57. (Article (55) grants a private cause of action for investors to sue for compensation incurred because of a misleading prospectus. Article (56) provides a private right of action for investors to claim compensation for damages against any person who has made a misrepresentation that misleads another in relation to the sale or the purchase of a security. Article (57)(a) grants a private right of action to claim damage against any person who has committed intentional manipulation on a security price activity in violation of Article (49) of the CML.) *See Gouda, supra* note *161*, at 120, 162.

are not subject to the statute of limitations stated under Article (58) of the CML. Therefore, the defense of a statute of limitations is not a valid action.[1820]

No Private Cause of Action Available Against Illegal Insider Trading Violators

The CML does not contain an article providing any private cause of action for investors against illegal corporate insider trading violators. In addition, the private right of action has been rejected by the ACRSD.[1821] In an illegal corporate insider trading case brought by a private investor, the ACRSD asserted that the prohibition of illegal corporate insider trading under Article (50) of the CML is a penal violation and the general rules state that criminal sanctions and penalties must be limited to criminal offenses.[1822] However, the ACRSD stated that an injured investor because of an illegal corporate insider trading act is entitled to sue for damages when he/she can prove the suffering of damages and can link the suffered damages to the violation of the defendant.[1823] The ACRSD stated that illegal corporate insider trading violators will not be held liable to compensate investors for damages unless three elements exist: a fault committed by the defendant, suffering of damages by the plaintiff, and a causal relation between the fault committed and the damages suffered.[1824]

[1820] *See Gouda, supra* note *161*, at 157.
[1821] ACRSD, Decision No.415/ L.S/ 2011 of 1433, season of 1/2/1433H (corresponding to Dec 26, 2011), P.2, *available at*: http://crsd.org.sa/en/AppealsCommittee/Decisions/Documents/415-33E.pdf. (The plaintiff's suit was based on an allegation that the defendant traded based on inside information and was charged by the Committee for Illegal Insider Trading. *Id*. at 1. The plaintiff claimed that he purchased shares in the same company during the same time the illegal insider trading violation took place, and because of the insider selling activity on the stock, the stock price rapidly plunged in value which caused the plaintiff to suffer loss in an amount equal to SR1,522,000 million ($405,866.667 thousand). *Id*. In 2011, the Committee dismissed the case, and the plaintiff appealed.) *Id*. at 1.
[1822] *Id*. at P. 2.
[1823] *Id*.
[1824] *Id*. (In this case, the ACRSD stated that the plaintiff purchased the shares during the time the violation was committed, then sold them several months after the violation. Thus, the claimant "was not able to prove before the Appeal Committee the relation linking the damages he alleged and the violation of the respondent." As a result, this lack of demonstrating the casual relation is sufficient to show that the violation of the respondent did not cause the damages alleged by the plaintiff. Thus, no compensation should be award.) *Id*.

In general, the private cause of action is unavailable for investors who claim injury because of illegal corporate insider trading activity since there is no express article within the CML that grants the right to sue. In addition, proof of a causal connection between the damages suffered by investors trading at the time of illegal corporate insider trading in the Exchange is very difficult or almost impossible to prove since there is no inducement by the illegal corporate insider trading violator, and the lack of reliance by investors.

Summary

Part 4 discusses the government's enforcement of the prohibition of illegal corporate insider trading in Saudi Arabia. It describes the elements of liability, the acceptable standard of proof, and the potential sanctions and penalties for violations of the prohibition. It reveals that liability upon corporate insiders includes three elements: (1) the occupation of an insider's status gives access to inside information, (2) a direct or indirect trade of a security related to inside information that meets the statutory attributes of inside information, or (3) the disclosure of such information to an outsider, while the insider knows that he/she is in possession of inside information that has not been disclosed to the public. Outsiders' liability is the same as insiders except that outsiders do not need to have an insider status that gives legal access to inside information.

One important aspect of this part is that the violation of the prohibition is treated as a criminal violation. The standard of proof is flexible in illegal corporate insider trading cases where the prosecution can prove the perpetration of the violation by direct or circumstantial evidence. This part shows that after a conviction in illegal corporate insider trading proceedings, wrongdoers are subject to several sanctions and penalties. The major sanctions are being banned from working as a director or officer in listed companies, disgorgement of ill-gotten gains or losses avoided, fines up to $26,666, and imprisonment not exceeding five years.

Part 5. Summary of Chapter 3

Chapter 3 describes Saudi Arabian regulations of corporate insider trading. The examination of the regulations focuses on answering three questions: (1) Why are corporate insiders' trades and securities ownership regulated by securities regulations? (2) What differentiates them from other investors? and (3) When can insiders can trade legally and when are they prohibited from trading?

This chapter reveals that corporate insiders are subject to a fiduciary or trustee duty to pursue the interests of the company and must refrain from acts that involve conflict of interest or misuse of confidential information unless specific consent is given. By enacting the CML, Saudi Arabian regulators recognized the need to place more restrictions upon corporate insiders whether to prevent them from misusing the inside information available to them because of their privy position or to foster the transparency and disclosure policy of the CML. Corporate insiders are required to publicly disclose their securities ownership of their corporation equity security and their trading transactions that result in a change of such ownership. However, a three-day period to disclose after the execution of the transaction gives the public late market information that is not valuable unless it were disclosed before or within the same day of trading. This chapter also shows that corporate directors and senior executives are subject to lock-up periods that require them to abstain from trading in their companies' securities 15 days before financial quarters and until public disclosure and 30 days before the end of the issuer's fiscal year until the announcement of the annual report.

Although Saudi Arabian regulators have recognized the need to regulate corporate insiders due to their strategic positions as inside issuers, they approached the misuse of inside information for trading purposes in a broad prohibition reach based on the parity of access to information theory. The prohibition includes traditional insiders and others who obtain inside information through a special relationship (family, business, or contractual relationship). The reach of the prohibition is also broader covering corporate outsiders who trade on inside information when they know that the information is inside information.

While the distinction between legal and illegal corporate insider trading can be a difficult task for corporate insiders, they are legally allowed to trade after taking precautions if they are not aware of or in possession of inside information and the trade is outside the lock-up periods. Such precautions may include asking the management if they are allowed to trade. Measures can also include refraining from trading anytime an insider is uncertain about whether he is in possession of inside information or not.

Chapter 4. Comparative Analysis between U.S. and Saudi Arabian Corporate Insider Trading Regulations

Introduction

After examining the regulations of corporate insider trading in the United States and Saudi Arabia, this chapter compares the two countries' regulations. Although the countries' regulations and treatment of corporate insider trading are not the same, they share considerable similarities on the legality question about insider trades and the rules governing their trades and securities ownership. Both countries have treated corporate insiders as a special class of traders and have subjected them to restrictions and rules due to the special position they hold as inside issuers of securities. Both countries' regulations prohibit corporate insiders from misusing inside information by either trading on or tipping others to trade before public disclosure of inside information. They also require insiders to publicly disclose their ownership of securities and trading activities in a timely manner. In this sense, corporate insider trading regulations in the United States and Saudi Arabia are mostly similar. However, the two countries have different approaches to how insiders' trades are regulated, and the sophistication of how the rules are applied. They also have different limitations and reach of the prohibition of illegal corporate insider trading. To better state the similarities and differences between the two countries' corporate insider trading regulations, this chapter offers a hypothetical case to illustrate how the U.S. and Saudi Arabian regulations would be applied. This chapter then provides a discussion of the resulting comparison.

Hypothetical Case

Assume that there is a medium-size public corporation whose stock is registered and traded in the national exchange. The name of the company is Palms Coffee, a Palms State public corporation, which is a retail company selling roasted specialty coffee. It has more than 1,000 stores in Palms state. Its stock is quoted at $28 per stock, and it is a very successful company. The company is often covered by the national news media and press reports and the stock is followed by professional securities and large financial institutions. The company files all required mandatory reports with the national regulatory agency responsible for supervising and enforcing the securities laws of the national exchange. These reports include annual and quarterly reports that give detailed information about the financial position of the company and its prospective growth as assessed by the company's management staff. In addition, the company is required to disclose specific material information as soon as the company's management discovers or creates the information.

Facts

In January 2016, S.J., the CEO of the company presented a new business expansion plan to the Board of Directors in which the corporation would acquire a company that made special coffee makers. The purpose of the project was to establish a second business line besides selling coffee and pastries at their 1,000 coffee stores. The projection was that this project would increase the corporation's estimated revenue for the next three years by 15%. By majority vote, the board of directors decided to adopt this plan and to authorize the CEO of the company to start acquisition negotiations with the target company. This decision was disclosed to the public through regulatory means. By November 2016, the corporation announced its acquisition of the coffee maker products. After the public disclosure, the price of the stock went up by 10% to $30.8 in two trading days.

One of the directors (director A.B., a large shareholder of Palms Coffee) had disagreed with the decision to adopt this project at the board meeting because he believed that it would not be profitable based on his long experience in the coffee industry. After the meeting, he wrote a trading plan to sell most of his stockholdings in the corporation, which would be executed over a 1-year period. However, Director A.B. instructed his broker not to sell any stock until two days after the corporation's public disclosure about their expansion plan. The Palm's CEO also purchased 1000 common stocks of Palms. In early 2017, the company experienced slow sales growth of the coffee makers products and the company publicly disclosed this slow growth within its first quarter earnings report. However, other low sales revenues started to emerge for other business lines, but the management decided that it was not material to inform the board or to disclose this information to the public. Between April and August of 2017, the CEO of the company, S.J., sold almost half of his stockholdings in the corporation. The sales of stocks by the CEO started after a brief meeting with the CFO of the corporation in April 2017.

In November and December of 2017, the corporation experienced unexpected and significantly low sales of all its business lines including its coffee maker products. By the end of the 2017 fiscal year, the corporation recorded a loss of 10% of its total assets. The CEO and CFO sent an email marked urgent and confidential to the board of directors to inform the directors about the new development of incurring the unexpected and significant losses. On December 19, 2017, Director B.A. was on the phone with his wife when he received an email from Palm's management. He told his wife about the financial problem but told her not to tell anyone about this information because it was confidential. Later, B.A.'s wife, C.A., told her father, A.D., that Palms Coffee had terrible news regarding their earnings for that year. She also told her father not to tell anyone else about this information because her husband told her that this information was confidential. However, A.D. immediately called his broker to sell his 2000 shares in Palms Coffee.

On the same day, Director B.A. had a gathering with his friends. While he was with his friends, B.B., the best friend of Director B.A. asked the director about the Palms Coffee business. Director B.A. told B.B. that the corporation was facing a lower earnings revenue from what had been publicly expected including obstacles regarding the coffee maker products. However, B.A. cautioned his friend not to disclose this information to anyone because of the confidential nature of the information. While the director was talking to his best friend, someone sitting in an adjacent table overheard the conversation. This person, A.W., was an investor in Palm's stock and knew Director B.A. A.W., immediately called his broker and instructed her to purchase put options and sell his stake in the corporation. A.W. also told his friend, H.R. about Palm Coffee's situation but did not tell him that the information came from the director. H.R., an investment manager at a large financial institution. H.R. passed this information to E.G., a security analyst specializing in the coffee industry, who disclosed the information to his manager, S.A. He said there were strong rumors that Palm Coffee Corporation's earnings for 2017 may be lower than expected because of slow sales growth including the coffee maker products. The manager then decided to sell one-third of the institution's holdings in the corporation. On December 22, 2017, the market stock price of the corporation sharply decreased to $24.8 per share. This dramatic decrease of the stock price alerted the Capital Market Authority to investigate whether some news had not been disclosed to the public. The Authority sent an inquiry to the corporation asking if there was any material information that had not been disclosed to the public. The corporation replied by making a public disclosure stating that the corporation's earnings had significantly decreased in November and December of 2017, which had affected the corporation's 2017 earnings by a decrease equal to 10% of the net assets of the corporation. After this public disclosure, the market stock price decreased by 4% from its price before the disclosure to $23.80 per share.

<u>Persons Vulnerable to Face Potential Corporate Insider Trading Liability based on the Facts</u>

From the facts of this hypothetical case, there are five situations where people may be vulnerable to penalties and sanctions under the coverage of corporate insider trading regulations.

1. A.B., the director of Palms Coffee Corporation who made a written trading plan, in November 2016, to sell his stockholdings in the corporation after the Board decided to expand the business by acquiring the coffee makers company. A.B. decided to sell his stockholdings based on his personal assessment that the acquisition of the coffee maker products would be unprofitable. He knew that the information related to acquiring the coffee maker company was inside information. Thus, he decided to create a written trading plan and instructed his broker to execute this plan after this inside information became public. A.B. specified the plan including the price, amounts, and dates of the trade so it would be executed over a one-year period.

2. S.J., the CEO of the corporation who traded on two separate occasions. He traded the first time when he purchased stock in November 2016, and the second time when he started to sell a substantial amount of his stock between April and August of 2017 after the corporation disclosed the slow sale growth of the coffee maker products publicly and following a meeting with the CFO.
3. A.D. who sold his entire stockholdings on December 19, 2017, after indirectly receiving confidential information from a director of Palms Coffee, B.A., through his wife, C.A., the daughter of A.D.
4. A.W., a shareholder of Palms Coffee, who sold his stock of the corporation and purchased put options on December 19, 2017, betting that the corporation's stock would decrease in value. A.W. received the information inadvertently when he overheard Palms' director, B.A.'s conversation with his best friend.
5. S.A., investment manager at a large investment institution, who sold a large amount of stock of the corporation based on information received form her employee, E.G., a security analyst who told the manager that information reflected rumors in the investment community. E.G. received the information from H.R. who obtained the information from A.W.

Content of Inside information in the Hypothetical Case

The inside information in this case was that Palms' Coffee Corporation had significantly lower earnings from what was already expected and publicly known in 2017 which recording a loss equal to 10 percent of the net assets of the corporation.

Application of U.S. Regulations

First Case: A.B. is a Section 16 insider since he is a director of Palms Coffee Corporation with registered stock in the national exchange. Therefore, A.B. is subject to reporting requirements and has an obligation to refrain from gaining short-swing profits. In addition, A.B. is a Rule 10b-5 corporate insider under the classical theory of illegal corporate insider trading subject to the prohibition from trading on the basis of material non-public information. Applying the U.S. regulations, A.B. must have publicly disclosed his trading by the end of the second business day following the execution of the transaction that resulted in a change of securities ownership. Assuming that the first sale transaction occurred on November 20, 2016, the public disclosure through filing Form 4 with the SEC was due by the end of the business day of November 22.[1825] A.B.'s trading was legal corporate insider trading where he did not misuse any inside information. His trades started after a reasonable waiting period after public disclosure—two-day. A.B. used a written trading plan that complied with the requirements set out in the SEC's Rule 10b5-1(c).[1826] Rule 10b5-1(c) granted corporate insiders an affirmative defense for trading transactions that occur while they are aware of inside information if the trading transaction is made pursuant to a trading written plan.[1827] As a result, A.B. most likely is not liable for trading on inside information because his initial trading was based on a personal assessment of the corporation's stock, which is completely legal. A.B.'s sale trading transactions during the time that he may have become aware of the experience of unexpected low sales were shielded from liability based on the written trading plan described in Rule 10b5-1(c). This

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[1825] *See supra* note 357 and accompanying text.
[1826] *See supra* notes 1077-91 and accompanying text.
[1827] *Id*.

is because A.B. did not use this inside information even though he was in possession of it at the time of the trade.

Second Case: S.J, the CEO of Palms Coffee, is a section 16 corporate insider and subject to the prohibition of illegal corporate insider trading under Rule 10b-5 based on the classical theory since he is a senior officer serving in the highest officer position in the corporation. S.J.'s first purchase of the shares in November 2016 must have been publicly reported to the SEC using Form 4 in accordance with Section 16(a) of the SEA as well as his later sale transactions. The purchase transaction was completely legal because it was made after the corporation publicly disclosed the acquisition of the coffee maker company; therefore, there was no misuse of inside information. However, the sale transactions that S.J. made from April to August of 2017 could be the basis of civil and criminal liability. First, the sale transactions in April can be matched with the purchase transaction made in November. Thus, the sale transaction would be matched against the purchase transaction to constitute a violation of Section 16(b)—short-swing profit. It can be assumed that the purchase transaction was made on November 10, 2016, and the sale transactions were made from April. 1-10, 2017 which resulted in making a profit. The corporation, or its shareholders in a derivative suit, have the right to seek a private civil lawsuit against S.J. to pay back the short-swing profit made from the purchase that was made in November 2016 and sales that were made in April. 2017. However, profits made from the sale transactions that exceeded the six-month period would not be subject to Section 16(b) of the SEA.[1828]

[1828] For more discussion about the matching the purchases and sales under Section 16(b), *see supra* notes 374-93 and accompanying text.

Another potential liability that S.J, could face is the sale transactions that he made from April to August 2017 after the corporation publicly disclosed the slow sales growth of the coffee maker products and following a brief meeting with the CFO of the corporation. The CEO is presumed to be aware of the business operation of the corporation and its developments. S.J.'s sale transactions were suspicious in timing, amounts, and circumstances. It was after public disclosure of the slow sales growth of the coffee maker products. However, the public did not know about the significantly slow sales of other business lines. The sale of half of his stockholding in the corporation after a brief meeting with the CFO of the corporation indicates that inside information was conveyed.

Third Case. A.D. is a corporate outsider and is not a Section 16 corporate insider. He has no special relationship with the corporation or its shareholders. Therefore, A.D. is not subject to the rule of the classical theory of illegal corporate insider trading. However, when A.D. received confidential information from his daughter, C.A., director B.A.'s wife, A.D. owed a duty of trust or confidence under the misappropriation theory not to misuse the confidential information for trading purposes.[1829] In accordance to Rule 10b5-2, director B.A.'s disclosure to his wife was not illegal because the disclosure was with the expectation of maintaining confidentiality either based on the marital relationship itself or based on the history, pattern, or practice between them to expect that she would maintain confidentiality or based on the express acceptance by C.A. to maintain the information in confidence.[1830] The same rule applies to C.A.'s disclosure to her father, A.D. As a result, A.D. would be likely to be found liable for selling his stockholdings in the corporation on the basis of material non-public information received in confidence from his daughter. The

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[1829] *See supra* notes 629-45 and accompanying text.
[1830] *Id*.

sale trading transactions occurred a short time after the phone call between the director and his wife and at the same time, the director received the email from the corporate management showing that inside information most likely was conveyed. To hold B.A. liable for tipping inside information, there must be additional evidence showing that improper disclosure was made because Rule 10b5-2 presumes that disclosure between family members is made lawfully with the expectation of maintaining the confidentiality of inside information.

Fourth Case. A.W., who was a shareholder of Palms Coffee, was not a Section 16 corporate insider nor did he have a fiduciary-like relationship with the corporation or its other shareholders. Therefore, he is not subject to Section 16 of the SEA and is not covered by the classical theory of corporate illegal corporate insider trading.[1831] He is a corporate outsider. A.W. received the information from B.A., a director of Palms Coffee. Determining whether A.W. is liable or not for trading on inside information hinges on finding out whether the disclosure or the tip by B.A. was improper. First, A.W. received an inadvertent tip by B.A. who disclosed the information to his friend, B.B. with a clear expectation and agreement of maintaining the confidentiality of the information. Therefore, B.A.'s disclosure to his friend was not improper in accordance with Rule 10b5-2. However, B.A.'s disclosure was careless since it allowed others, who he did not know, to acquire confidential information. Nevertheless, applying *Dirks'* standard, the tip of B.A. to A.W. was inadvertent and unintentional. Thus, the disclosure was without breach of fiduciary duty because it was not for personal benefit since the tipping for personal benefit requires the tip to be intentional or at least reckless. As a result, A.W.'s sale transaction of his

[1831] For a discussion about whether shareholders owe a fiduciary duty to one another, *see supra* note 249-50 and accompanying text.

stockholdings in the corporation was a lawful sale because the confidential information was inadvertently received and thus, A.W. did not owe a derivative fiduciary duty to the corporation or its shareholders.[1832]

Fifth Case. S.A. is not a Section 16 corporate insider nor a classical insider under the classical theory of illegal corporate insider trading. As an investment manager, she sold a substantial amount of stock in the corporation on December 19, 2017, based on information received from her employee E.G. that there was a strong rumor within the investment community that Palms' earnings for 2017 may be lower than expected because of slow sales growth. In addition to not being a classical insider, S.A., was not entrusted with the information nor did she receive the information as a fiduciary. Therefore, she did not owe an original fiduciary-like duty of trust or confidence. To be held liable for the sale transactions based on inside information, she must meet *Dirks's* standard, as a remote tippee.[1833] First, S.A. received the information from a chain of tippees where she was three levels removed from the original inside tipper, director B.A. Although E.G. told S.A. that the information originated from rumors, the content and specificity of the information should have raised a red flag for S.A. since she was a sophisticated investor and could distinguish rumors from inside information. However, to hold S.A. liable, she must have

[1832] A similar outcome to this scenario was decided in *SEC v. Switzer, 590 F. Supp. 756 (*W.D. Okla. 1984). (Barry Switzer overheard a conversation between an insider and his wife concerning a possible liquidation or sale of a public oil company. Switzer knew the insider. The insider testified that he did not know that Switzer was listening to the conversation. Switzer and several of his friends bought shares in the corporation. The court found that the insider did not breach his fiduciary duty to stockholders of the corporation under Rule 10b-5 when he disclosed the information to his wife because the information was given only to inform her of his up-coming business schedule that arrangements so child care could be made. The Court also concluded that the information was inadvertently overheard by Switzer, and "Rule 10b-5 does not bar trading on the basis of information inadvertently revealed by an insider." *Id*. at 764-67. *See LANGEVOORT, supra* note *6, at* §4:7. However, A.W. would likely be liable if the tip by director B.A. was made recklessly that he knew A.W. was listening and was a shareholder of the corporation. For a discussion about this issue, *see* John C. Jr. Coffee, *Introduction: Mapping the Future of Insider Trading Law: Of Boundaries, Gaps, and Strategies*, 2013 Colum. Bus. L. Rev. 281, 291 (2013).

[1833] *See supra* notes 817-26 and accompanying text.

known other facts in addition to the nature of the information. She must have known that the information was disclosed from an insider in a breach of his/her fiduciary duty for personal benefit. From the facts presented, the only information that S.A. knew was that the source of the information was E.G. who informed her that the information was circulating in the investment community. As a result, this scenario is tricky and the likelihood of facing illegal corporate insider trading liability may be based on alleging that, as a sophisticated investor, she knew or was reckless in not knowing that the information was inside information improperly disclosed from an insider. In addition, S.A.'s sale of a substantial number of shares at a suspicious time preceding the public disclosure of this information supports such an allegation.[1834] However, it is more likely that she would not be at least criminally liable because she did not have affirmative knowledge that the original inside tipper tipped the information for personal benefit and there were no circumstances known by S.A. that pointed in that direction.[1835] Supposing that E.G. told

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[1834] This potential allegation that arose under this case is similar to the allegation in *Newman*. In *Newman*, "the Government charged that Newman and Chiasson were criminally liable for insider trading because, as sophisticated traders, they must have known that information was disclosed by insiders in breach of a fiduciary duty, and not for any legitimate corporate purpose." *United States v. Newman*, 773 F.3d 438, 443 (2nd Cir. 2014). However, the Second Circuit rejected this allegation by concluding that: "a tippee's knowledge of the insider's breach necessarily requires knowledge that the insider disclosed confidential information in exchange for personal benefit." *Id*. at 449.

[1835] *Id*. at 450. The Second Circuit stated that: "Here both Chiasson and Newman contested their knowledge of any benefit received by the tippers and, in fact, elicited evidence sufficient to support a contrary finding. Moreover, we conclude that the Government's evidence of any personal benefit received by the insiders was insufficient to establish tipper liability from which Chiasson and Newman's purported tippee liability would derive." The Second Circuit also found that: "Even assuming that the scant evidence described above was sufficient to permit the inference of a personal benefit, which we conclude it was not, the Government presented absolutely no testimony or any other evidence that Newman and Chiasson knew that they were trading on information obtained from insiders, or that those insiders received any benefit in exchange for such disclosures, or even that Newman and Chiasson consciously avoided learning of these facts. As discussed above, the Government is required to prove beyond a reasonable doubt that Newman and Chiasson knew that the insiders received a personal benefit in exchange for disclosing confidential information." *Id*. at 453. For more discussion of possible difference between civil and criminal lability for remote tippees, *see supra* note 820.

S.A. that the original inside tipper was B.A. who disclosed this information inadvertently to A.W., it is most likely that S.A. would not be liable like A.W.'s trade.[1836]

<u>Question of Material Non-public Information</u>

In this hypothetical case, the inside information is the significant loss of earnings for the 2017 fiscal year, which was unknown to the public. This information is related to the earnings power of the corporation, which is the most likely information to be considered material information. The disclosure of the information would be reasonably viewed by a reasonable investor that it has significantly altered the total mix of information made available. Therefore, it is unlikely that anyone would question whether the earnings information is material or not. However, the materiality question can be argued in this hypothetical situation concerning S.J., the CEO, by assuming that he received information regarding the earnings power of the corporation from the CFO in April 2017. The information at that time was contingent and speculative. He may argue that the significant loss occurred in November and December four to five months after his last trade. Therefore, the information was not a true fact but rather probable. Thus, it was not inside information. However, based on multiple judicial tests (i.e., the test of probability and magnitude, the test of the importance attached to the information, and the test of the reaction of the market after disclosure), it is most likely that this argument would fail. First, to consider information to be material, it does not need to be certain.[1837] Second, the importance S.J. attached to the information when he sold half of his stockholdings in the company after a brief meeting with the CFO and while the public was not aware of probable significant

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[1836] *See supra* note 1832.
[1837] *See supra* notes 907-43 and accompanying text.

decrease of the company's earnings, shows that S.J. treated the information as material since it would alter the total mix of information publicly available.[1838] Third, the reaction of the market after public disclosure strongly indicates that the information was material information.[1839] This inside information became public knowledge after the disclosure made by the company in response to the national capital market authority which was filed with the authority and disseminated through national news. Assuming that the public disclosure was made only through a press statement in a national news agency, it would still be considered that the public disclosure transferred the information from being non-public to public.[1840]

<u>**Application of Saudi Arabian Regulations**</u>

First Case. A.B., a director of the company, is subject to Article (33)(e) of the Listing Rules, which requires public disclosure of initial ownership and changes of ownership of securities held in the company.[1841] He is also a statutory insider, expressly named by his position under Article (4)(b) of the MCR, making him subject to the prohibition of illegal corporate insider trading.[1842] A.B.'s trading transactions were required to be publicly disclosed by the corporation to the Exchange by the end of the third business day following the execution of each transaction. If the sale transaction occurred on November 20, 2016, the public disclosure would be due on November 23. Next, A.B.'s sale trading transactions were made based on a written trading plan that he instructed his broker to execute after two business days following the public disclosure. This is a

[1838] *See supra* notes 958-65 and accompanying text.
[1839] *See supra* notes 944-57 and accompanying text.
[1840] *See supra* notes 970-1020 and accompanying text.
[1841] *See supra* notes 1362-66 and accompanying text.
[1842] *See supra* notes 1469-83 and accompanying text.

completely legal trade because the trade was based on A.B.'s personal assessment not on inside information and the time of the trade was made after public disclosure.[1843] Therefore, public investors would have been able to trade based on equal access to information with the director. However, it is possible that A.B.'s sale trading transactions from November to December of 2017, when A.B.'s was aware of the inside information in question, be led to an allegation of violating the illegal corporate insider trading prohibition even though non-use of the information can be shown.[1844]

Second Case. S.J. is the CEO of the company and thus is subject to the public disclosure rules under Article (33) of the Listing Rules. He is one of the primary insiders named by their positions under Article (4)(b) of the MCR, making him subject to the prohibition of illegal corporate insider trading. S.J.'s trading must have been publicly disclosed by the corporation to the Exchange. S.J.'s purchase transaction in November 2016 was completely legal since it was not made on inside information and the time of the trade was executed after public disclosure. However, S.J.'s sale transactions from April to August 2017 can be under the scrutiny of CMA and may become subject to liability for trading on inside information under Article (50)(a) of the CML because of the suspicious nature of the trade and surrounding circumstances. As a CEO, S.J. is presumed by law to be aware of the day-to-day business operations and developments including confidential information regarding the corporation.[1845] During the time of the sale transactions, the public only knew about the slow sale growth of the coffee makers but was not aware of any other probable decrease in earnings for other business lines of the company. It is likely

[1843] *See supra* notes 1594-95 and accompanying text.
[1844] *Id*.
[1845] *See supra* notes 1478-83 and accompanying text.

that S.J. was trading on inside information given S.J.'s sale of half of his stockholdings in the corporation in a short period of time and after a brief meeting with the CFO of the company and while the public was not aware of the material confidential information regarding the earnings power of the company. Therefore, liability is expected to ensue.

Third Case. A.D. is not a director, senior executive, or substantial shareholder of the corporation. However, he has a family relationship with B.A., a director of Palms Corporation. Therefore, he is a statutory insider under Article (50)(a) of the CML and Article (4)(b) of the MCR.[1846] A.D. is not required to publicly disclose the sale transactions of his stockholdings in Palms. The sale transactions were made before public disclosure of bad news regarding the corporation's earnings. As a result, A.D. would likely face liability for trading on inside information in violation of Article (50)(a) of the CML. A.D. is presumed by law to have the status of an insider.[1847] The access to inside information is assumed to have occurred through his daughter, C.A. As a result, A.D. may be found liable for trading on inside information before public disclosure. The timing of the trade plays a significant role in arriving at this probable conclusion since the trade was made shortly after the end of the phone call between B.A. and his wife, C.A. It could be proven that inside information was obtained by B.A while he was talking to his wife. In addition, the selling the entire stockholdings reveals that the decision to sell was prompt and suspicious preceding public disclosure. It is unclear whether B.A. and C.A. would be held liable for improper disclosure because of A.D.'s trade.

[1846] *See supra* notes 1489-1500 and accompanying text.
[1847] *Id*.

Fourth Case. A.W. is not subject to securities ownership disclosure since he is not a substantial shareholder, director, or senior executive. A.W. also is not a statutory insider specified in Article (50)(a) of the CML and Article (4)(b) of the MCR. He is an outsider.[1848] To find A.W. liable, his conduct must be in violation of Article (50)(b) of the CML and Article (6)(b) of the MCR.[1849] A.W. sold his stockholdings and purchased put options in the company after obtaining inside information from B.A., a director, who revealed the information to his friend while A.W. was listening to the conversation. There are two possible allegations of violating the prohibition from illegal corporate insider trading against B.A. and A.W. B.A. may face two allegations: improper disclosure to his friend B.B., and unlawful disclosure of inside information to A.W. for trading purposes. B.A. disclosed confidential information to his friend, B.B., So, this disclosure could be in violation of A.B.'s duty to maintain confidentiality of the information under Article 5(a) of the MCR. Thus, the disclosure can be considered improper. However, although it is possible to hold A.B. liable for unlawful disclosure of inside information, it is likely that he would not be liable because the disclosure was not made on the understanding that B.B. would trade on this information or that there was an expectation that a trade would follow as required in Article (50)(b). Regarding the second possible allegation against B.A., although the disclosure to B.B. may be viewed as improper, the disclosure to A.W. was made unintentionally and he would likely not be held liable since the liability for improper disclosure requires the disclosure to be intentional. On the other hand, A.W. received the information in an indirect way while he was listening to the conversation. A.W. knew that the information was inside information that was unknown to the public. It is likely that

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[1848] *See supra* notes 1548-50 and accompanying text.
[1849] *Id*.

A.W.'s trade would be viewed as a violation of the prohibition of illegal corporate insider trading because the trade was in violation of investors' expectation of equal access to information since the trade took place at a time the public was not aware of such information that was known to be important and confidential. A.W.'s trade would be alleged to be in violation of Article (6)(b) of the MCR which prohibits trading on obtained information from another person known to be inside information or he should have known.

Fifth Case. S.A. is not a substantial shareholder, director, or a senior executive in Palms Coffee Corporation. She is also not a statutory insider under Article (50)(a) of the CML or Article (4)(b) of the MCR. She is an outsider. S.A. received the inside information in question from her employee, E.G., who received the information from H.R., who obtained the information from A.W., who originally overheard it from the director of Palms, B.A. However, S.A. only knew that the information was received from A.W., who told her that it reflected rumors circulated in the investment community. S.A. would likely face liability even if she did not know that the information was transferred through a chain of persons and originated from an insider. This is because S.A. is a sophisticated investor who would be able to distinguish inside information from rumors. In addition, the information received was specific and before the end of the fiscal year. Therefore, S.A.'s sale transactions for a large number of shares was suspicious and suggested that she knew that she was trading based on inside information even though she did not know whether or not the information was originated from an insider or not. However, E.G. is unlikely to be liable for tipping inside information because Article (5)(b) of the MCR only prohibits outsiders from disclosing inside information obtained from an insider. Therefore, based on the presented facts, E.G. was not aware that the information was obtained from an insider; thus, he would not be liable for disclosing the information.

<u>Question of Material Non-public Information</u>

The information in this hypothetical case is about the significant decrease in the company's earnings for fiscal year of 2017. It can be said that this information is material information according to the law.[1850] Specifically, earnings power is information that CML considers to be material and shall be protected from misuse until public disclosure in accordance with Article (45)(c) of the CML. This determination is based on the following reasoning: CML regards the public disclosure of earnings power if a reasonable person would consider that it could significantly affect the price or value of the related security. This effect could be proven to occur based on Palms' announcement that the decrease in earnings was equal to 10 percent of the net assets of the company. The subsequent decrease in the price of the security after the announcement also implies the same conclusion. The information became public after the public disclosure made by Palms in response to the Capital Market Authority which was made through electronic filing with the Authority and the Exchange. Assuming that the disclosure was made only through a national news agency and then to the general public, it is unclear whether this method would be considered a recognizable method of dissemination by the CMA. However, it is suggested that the press release was enough to transfer the information to the public since it fulfilled the goal of equal access to information to the general public through the news media.

[1850] This information is related to one of the events that an issuer has a mandatory obligation to disclose as soon as it is discovered. *See supra* note 1653.

Comparative Results from Applying the U.S. and Saudi Arabian Regulations to the Hypothetical Case

As for the application of U.S. and Saudi Arabian corporate insider trading regulations on the facts, this hypothetical case reveals important results that should shed light on the similarities and differences between the two countries' regulations. Table 1 shows the results of the hypothetical case under the two regulations:

Table 1: Comparative Results

Cases	Probative Facts	U.S. Regulations			Saudi Arabian Regulations			Result
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A.B.	1-Traded after public disclosure based on his personal assessment 2- Traded on a written trading plan before becoming aware of material non-public information.	Yes	Classical Insider (*Chiarella* & Rule 10b5-1)	1-Must disclose the trade to the public by the end of the second business day of the transaction 2-The trade was legal, and the written trading plan would shield him from liability even after being aware of inside information.	Yes	Primary Insider (Art. 50(a) of the CML &Art. 4(b) of the MCR)	1-Must disclose the change of ownership to the public by the third day following the date of the transaction. 2- The trade after public disclosure was completely legal 3-It is possible to be held liable for trading on inside information while being aware of such information disregarding the fact that the trade was made pursuant to a written plan	Both regulations have mostly similar results. The difference is: (1) the time of disclosure, 2 v. 3 days; and (2) whether adopting a written trading plan would provide an affirmative defense against illegal corporate insider trading liability. In the United States, the answer is yes. In Saudi Arabia it is no.
S.J.	1-Pruchased shares after public disclosure in November 2016 2-Sale transactions between April to August 2017 before public disclosure of bad news	Yes	Classical Insider (*Chiarella*)	1-Must disclose to the public his trading transactions to the public. 2-The purchase transactions were legal. 3-Possible violation of S. 16(b) (Purchase and sale within a six-month period). 4-He is likely to face illegal corporate insider trading liability for April to August sale transactions.	Yes	Primary Insider (Art. 50(a) of the CML &Art. 4(b) of the MCR)	1- Must disclose the change of ownership to the public by the third day following the date of the transaction. 2-The purchase transactions were legal (no inside information misused). 3- He is likely to face illegal corporate insider trading liability for April to August sale transactions.	Both regulations provide similar outcomes. The differences are: (1) the time of disclosure, 2 v. 3 days; and (2) In the United States, S.J. is likely to be held liable in the U.S. for violating S.16(b) by making a short-swing profit. However, he is not liable in Saudi Arabia for the purchase and sale within a six-month period.

A.D.	Sold entire stockholdings in the corporation after receiving confidential information from his daughter, C.A. (director B.A.'s wife).	No	Family member covered under the misappropriation theory (*O'Hagan* & Rule 10b5-2).	1-He is likely to face illegal corporate insider trading liability for misappropriating information received in confidence. 2-The sources of the information are most likely not liable because the information was conveyed with the expectation of maintaining confidentiality.	No	Secondary Insider (Art. 50(a) of the CML &Art. 4(b) of the MCR)	1- He is likely to face illegal corporate insider trading liability. 2-It is not clear whether director B.A. and his wife, C.A. would be liable for improper disclosure.	Both regulations provide similar outcomes. The only difference is that the source of the information is more likely to be held liable in Saudi Arabia than the U.S.
A.W.	Sold his stockholding on inside information received in an inadvertent way from director B.A. who disclosed the information to his friend, B.B. with the clear expectation and agreement of maintaining confidentiality of the information.	No	Tipper/Tppee (*Dirks*' standard)	He is likely to not be liable because the tip was not for personal benefit. It was an unintentional tip. Thus, A.W. did not owe a derivative fiduciary duty to the corporation or its shareholders.	No	Outsider (Art. 50(b) of the CML & Art. 6(b) of the MCR)	1-It is likely that A.W. would be held liable for trading on information known to be confidential and material in violation of Art. 6(b) of the MCR. 2-It is likely that B.A. would not be held liable for the improper disclosure because it was made unintentionally.	The regulations have different results. A.W. is more likely to be held liable in Saudi Arabia than the U.S.
S.A.	Sold a substantial amount of stockholdings in the corporation based on received information from her employee E.G., who stated that there was a strong rumor within the investment community that Palms' earnings for 2017 may be lower than expected because of slow sales growth.	No	Tipper/Tipeee (*Dirks'* standard)	This case is a tricky case. She is likely to be liable because as a sophisticated investor she was reckless in trading on inside information. It is also likely that she would not be held liable because she did not know the inside tipper gained personal benefit from the disclosure. It is more likely that at least she would not be criminally liable.	No	Outsider (Art. 50(b) of the CML & Art. 6(b) of the MCR)	S.A. is likely to face liability even if she did not know that the information was transferred through a chain of persons and originated from an insider. The information received was specific and preceding the end of the fiscal year. The trading pattern and timing suggest that S.A. knew that the information was inside information.	This case is a tricky one in the U.S. and it is likely that civil liability may follow, but not criminal liability. However, in Saudi Arabia, it is likely that S.A. would be held liable.
The Question of Material Non-public Information	The information related to the significant decrease in the company's earnings for fiscal year 2017.	--	There is a substantial likelihood that the disclosure of the omitted fact would have been viewed by a reasonable investor as having significantly altered the total mix of information made available to the public. (*TSC Industries, Inc.*)	Under the test of probability and magnitude and the test of the importance attached to the information, this information is likely to be material	--	Art. (50)(a) & Art. (4)(c) of the MCR (information is of the type that a normal person would realize that in view of the nature and content of this information, its release and availability would have a material effect on the price or value of a Security related to such information.)	This information is material since it is related to the earnings power of the issuer.	Both regulations have similar outcomes

After applying the two countries' regulations to the facts of this hypothetical case, the results reveal that both countries' regulations agree that corporate insiders shall be subject to more restrictions and rules because they constitute a special class of traders.

A.B. and S.J. are treated as traditional corporate insiders under both regulations. They must have disclosed their trading activities to the public in a timely manner: two business days in the U.S. and three business days in Saudi Arabia. The two countries regulations agree that the trades by A.B. and S.J. after the public disclosure in November 2016 were completely legal corporate insider trading. They also agree that S.J.'s sale transactions from April to August 2017 are likely to face illegal corporate insider trading liability. However, the two regulations disagree in the other parts of A.B.'s and S.J.'s trades. A.B.'s sale transactions pursuant to a written trading plan would not shield him from liability in Saudi Arabia when the trades took place at a time that A.B. was likely to know about the significant decrease in the sales revenue of the company. In contrast, the written trading plan would shield A.B. from liability in the U.S. S.J. can be civilly liable in the U.S. under Section 16(b) of the SEA to the corporation for the short swing profit made between the purchase transaction in November 2016 and the sale transactions in April 2017 that occurred within a period of less than six months. However, S.J. would not be civilly liable in Saudi Arabia.

Both regulations agree that A.D. is covered under the prohibition reach not as a tippee but as one who has an original duty as much as traditional insider to refrain from trading or tipping the information to others. A.D. is likely to be liable in both countries. Regarding A.W.'s case, the two regulations have different outcomes. In Saudi Arabia, he is likely to be liable for trading on inside information known to be obtained from an insider and yet unknown to the public. However, the disclosing insider, B.A., would not likely be subject to liability because his disclosure was unintentional. In contrast, it is less likely that the U.S. would hold A.W. liable because the disclosure was made inadvertently and, therefore, unactionable under Rule 10b-5. In addition, B.A. would not be held liable for the same reason. However, S.A.'s case is the most difficult and tricky case under both regulations. On the one hand, civil liability may ensue from S.A.'s sale trading transaction but not incur criminal liability because S.A. did not know that the inside tipper disclosed the information for personal benefit. On the other hand, it is likely that S.A. would face criminal liability for her trades even though she did not know the information originated from an insider.

<u>Remarks on the Results of the Comparative Analysis between the U.S. and Saudi Arabian Regulations</u>

Comparing the U.S. and Saudi Arabian regulations provides a good example of the pros and cons of having specific written provisions that govern corporate insider trading or leaving the case to develop by judges. Are there any genuine differences between adopting the framework of this law or the other? Although the two regulations seem different at face value, they are, in fact, mostly similar in application. Professor Franklin Gevurtz cited Bismakr's comment to describe this issue, "[I]n both cases, public confidence might be better served if people saw only the end result rather than how the item was made."[1851]

a. <u>Comparing the Substantive Law</u>

The comparison between the two countries' regulations reveals that both regulations have similar outcomes in most scenarios even if the justifications to determine outcomes differ. The structure of the U.S. law is partially based on the statutory provisions of Section 16 of the SEA. However, Section 16 does not prohibit corporate insiders from trading on inside information that is available to them because of their privy position even

[1851] *Gevurtz*, *supra* note 36, at 70.

though Congress has been concerned about this issue. The law that prohibits corporate insiders from trading on inside information is a judge-made law based on the interpretation of the anti-fraud provision of Section 10(b) of the SEA and Rule 10b-5. The current status of this judge-made law is a result of continuing developments and changes in the form and depth of the law over more than 55 years. In contrast, Saudi Arabian regulations of corporate insider trading are newly written regulatory laws. Both regulations recognize the importance of corporate insiders' positions inside listed corporations which subjects them to restricted rules and treats them as a special class of traders. Both regulations require public disclosure from traditional corporate insiders, directors, senior officers and substantial shareholders because of their actual or constructive control over corporations. Because insiders have access to inside information which may give them an informational advantage over public investors, both regulations seek to prevent insiders from having an unjust advantage at the expense of public investors who have no means to attain the same advantage. United States federal securities laws have combated this unfair trading practice by prohibiting corporate insiders from making short-swing profits within a period less than six months under Section 16(b) of the SEA. The SEC and federal courts have created a prohibition from trading on the basis of inside information. Although the prohibition covers corporate insiders as well as outsiders, the prohibition of trading on material non-public information is restricted by requiring proof of a breach of fiduciary duty. Corporate insiders are liable for disclosing material non-public information when the disclosure is in breach of their fiduciary duty of loyalty when the disclosure is made for personal benefit. The prohibition from illegal corporate insider trading that extends to corporate outsiders can be based on a breach of the fiduciary-like relationship owed to the source of the information or when the trade is made when the outsider knows that the information is directly or indirectly disclosed by an insider in breach of his/her fiduciary duty for personal benefit. This restriction of the reach of the prohibition is based on the Supreme Court's recognition that there is no express provision in the SEA stating that all investors have a reasonable expectation of equal access to information. In contrast, Saudi Arabia has combated illegal corporate insider trading by providing a more general and broader prohibition than the United States. Saudi Arabian regulations contain a written statutory provision. Article (50) of the CML prohibits insiders from misusing inside information before public disclosure. The Saudi Arabian theory that underlies the broad prohibition is that investors shall have equal access to information. The policy of the CML is to require issuers to fully disclose material information as soon as it occurs. CMA interprets this duty by considering that any misuse of inside information before public disclosure shall be prevented.

b. Comparing the Certainty and Predictability of the Two Regulations

This comparison of the two regulations relates to whether the two regulations are clear and certain. The results show that having statutory written provisions provides more clarity to the law, but a broad prohibition would be the wrong choice because of the uncertainty that comes with broad language on prohibition in most scenarios.

The Saudi Arabian regulations include a detailed description of the prohibited conduct of illegal corporate insider trading, the persons subject to the prohibition, the meaning of inside information, and the culpable state of mind. This specificity of the ruling on illegal corporate insider trading is one of the greatest advantages of having written regulations. It helps corporate insiders and others to predict with more accuracy what the law prohibits and how to avoid liability in advance. It also gives enforcement personnel and judges adequate guidelines about the substance of the law and goals that it aims to achieve.

The application of the two countries' regulations reveals that both regulations of illegal corporate insider trading go beyond prohibiting traditional corporate insiders from misusing inside information in breach of their fiduciary duty to prohibit corporate outsiders from trading on the basis of an informational advantage before the public has the same information. However, the application of both regulations shows that they continue to suffer from uncertainty, either in the reach of the prohibition or the predictability of the law.

The main notable aspect of the application of the Saudi Arabian regulations is that the regulations of illegal corporate insider trading, in particular, the CMA's implementing regulations, have imposed a broad prohibition of illegal corporate insider trading that goes beyond corporate insiders and even people who have regular access to inside information. Although it can be agreed that the CMA has the rulemaking authority to interpret the statutory provision of Article (50) of the CML, the tendency of the CMA to create a broad approach has led to conflicting interpretations of Article (50) of the CML, which has made the law difficult to understand or predict.

In contrast, the U.S. illegal corporate insider trading law lacks some written statutory provisions that determine the prohibited conduct with specificity including who is subject to the prohibition except for Rule 14e-3, which only governs trading on inside information related to a tender offer. This lack of statutory provisions has led to several discoveries of theories that differ from a legal basis and justifications, which causes the law to be uncertain and confusing.[1852] Professor Donald Langevoort commented on this issue by stating that the core motivation underlying the prohibition of illegal corporate insider trading in the United States (i.e., "fiduciary duty and fair play concepts,") is the key to understanding the current status of the law. However, Professor Langevoort noted that:

> [T]he subjectivity of the law's motivation is also a source of confusion. Neither fair play nor fiduciary duty is a particularly well-defined concept; there is much room for disagreement over whether given trading instances contravene these standards. The desire to have an expansive and flexible reach to the prohibition in order to remedy all perceived wrongs, however, is inevitably in tension with another strong desire given prominence in recent securities law jurisprudence, the need for predictability and clarity in the law. Much

[1852] The timeline of the development of the illegal insider trading law shows that the prohibition started with a broad status-based that goes beyond traditional insiders to include persons who acquire inside information because of a special relationship (the SEC's *Cady, Roberts*). Then it developed into a possessing-based law that prohibited anyone with possession of inside information from trading or tipping others (the Second Circuit in *Texas Gulf Sulphur*), *SEC. & Texas Gulf Sulphur CO.,*401 F.2d 833 (2d Cir. 1968). However, although the SEC and the Second Circuit went back to restrict the law to be status-based to only cover persons with regular access to inside information (Second Circuit in *Chairella*), *U.S. v. Chiarella*, 588 F.2d 1358 (2nd Cir. 1978), the Supreme Court restricted the reach of the prohibition to cover only traditional corporate insiders and others who owe fiduciary duty to the shareholder (the Supreme Court in *Chairella*), *Chiarella v. United States*, 445 U.S. 222 (1980). Then, the reach of the law became broader again to cover corporate outsiders who misappropriate inside information in breach of fiduciary duty owed to the source of the information (the Supreme Court in O'Hagan), *U.S. v. O'Hagan, 521 U.S. 642 (1997).* For a discussion of the timeline of the development of the law, *see Langevoort*, *supra* note 80. In subsequent years of *O'Hagan*, the fiduciary-like paradigm also diminished, as Professor Donna Nagy noted after examining the following lower courts' opinions and the SEC administrative rules. For example, the SEC's rule 10b5-2 made the law even broader by rephrasing the term "duty of trust and confidence" to be "duty of trust *or* confidence." This rephrasing increased the limit of the misappropriation theory to include circumstances that did not constitute a breach of fiduciary duty. *Nagy*, *supra* note 417, at 1340. (Professor Donna Nagy asserted that: "To be sure, the terms "trust" and "confidence" are often used synonymously to describe reliance on the character or ability of someone to act in a right and proper way. However, as used in Rule 10b5-2, the term "confidence" may align more with an obligation of "confidentiality" than with obligations predicated on trust and loyalty." Professor Nagy concludes that the expansion of the misappropriation theory to include persons who agree to maintain confidential information "simply dispenses" with the fiduciary principles.) *Id*. at 1360. *See* also *Smith, supra* note 207, at 1422. (Professor Gordon Smith suggested that: "This effort to override and expand on state fiduciary law suggests that the misappropriation theory is not about fiduciary relationships at all.") *Id*. Many commentators have argued for enacting statutory provisions for the sake of clarity and certainty of the law especially with the concern that defendants are severally sanctioned for undefined crime. *See* for example, Preet Bharara & Robert J. Jackson Jr, Insider Trading Law Haven't Kept Up with the Crooks, N.Y. Times, (Oct. 9, 2018), https://www.nytimes.com/2018/10/09/opinion/sec-insider-trading-united-states.html; Nagy, *supra* note 423, at 1366; Painter et al., *supra* note 257, at 211; *Karmel*, *supra* note 426, at 766; *Schipani & Seyhun*, *supra* note 424, at 363.

> of the complexity of the law of insider trading—something long recognized as a problem in this area —is a product of quixotic attempts by the courts to resolve this tension.[1853]

In contrast to the U.S. restrictions, the CMA's approach of broad prohibition upon anyone possessing inside information (the parity of information theory) is far broader than the current judge-made law of the United States or even the SEC's rules. The U.S. regulations are a status-based prohibition that affect two groups of persons, at most: (1) persons who wrongfully use inside information for trading purposes in a breach of the fiduciary-like relationship and persons who receive this information to trade when the tip is made for personal benefit and the recipient knows that the tip is improper; and (2) persons who acquire inside information in a manner that is deceptive (e.g., computer hackers).[1854] That said, it the recent developments including the SEC's rules, 10b5-1 and 10b5-2, and recent Supreme Court's decision, in *Salman*, have brought more certainty to the U.S. regulations for corporate illegal corporate insider trading than to those in Saudi Arabia. This finding is illustrated below.

From the facts of the hypothetical case presented in this chapter, in the U.S., director A.B. would be protected by Rule 10b5-1(c) using his written trading plan as an affirmative defense against allegations of trading on the basis of material non-public even after he was likely to be informed about such information. This rule protects corporate insiders from being liable for the mere fact of possessing inside information at the time of the trade which gives insiders more clarity and certainty about the legality of their trading activities. In contrast, Saudi Arabian regulations lack a compatible provision and it is uncertain that a written trading plan would be viewed as a justifiable reason to execute a

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[1853] *LANGEVOORT, supra* note *6, at* §1:6.
[1854] *See supra* notes 660-83 and accompanying text.

trade at a time when the corporate insider is aware of inside information before the disclosure to the public.

Director B.A.'s disclosure to his wife, C.A, who, in turn, disclosed the information to her father, A.D., was presumed to be made with the expectation of maintaining confidentiality in accordance with Rule 10b5-2(b)(1) and (3). Therefore, the disclosure is presumed to not be improper and liability may not ensue regarding illegal corporate insider trading liability upon B.A. or C.A. In contrast, Saudi Arabian regulations and practice could cause confusion about whether disclosure to family members is illegal or not with respect to illegal corporate insider trading regulations. While Article (50)(a) of the CML considers family members as an insiders, implying that their access to inside information is recognizable and based on a duty to refrain from misusing such information for trading purposes, in practice, the CMA has provided mixed signals regarding this issue. In particular, corporate insiders can be held liable for unlawful disclosure when a family member trades on inside information.[1855]

Under the U.S. regulations, an inadvertent tip of inside information, as in the case of A.W, is less likely to result in liability for trading on such information since the disclosure was not improper and conducted with no intent to facilitate trading. This provides more clarity to corporate insiders who make a negligent disclosure that it would not result in illegal corporate insider trading liability. In contrast, in Saudi Arabia, it is likely that A.W. would be held liable for violating Article (50)(b) of the CML and Article (6)(b) of the MCR. However, it is uncertain whether director A.B.'s disclosure would be viewed as a violation by itself. Article (50)(a) restricts the liability for improper disclosure

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[1855] *See* ACRSD, Decision No.973/ L.S/ 2015 of 1437 H, *supra* note 1452, P. 14.

to outsiders in situations that involve intentional disclosure in which the disclosing insider, at least subjectively, expects that the outsider recipient will trade. However, CMA's Article 5(a) of the MCR makes it unlawful to disclose even if the disclosing person does not expect that the outsider will trade but it is possible that he/she may trade. This negligent disclosure would be considered within the realm of criminal prohibition. Therefore, A.B.'s disclosure to his friend would create a considerable dilemma in determining the law in this scenario. One possibility is that the disclosure by itself was an illegal corporate insider trading violation and this view likely has valid grounds under Article (5)(a) of the MCR. Another possibility that the disclosure was not actionable under the prohibition of illegal corporate insider trading would be based on the language of Article (50)(a). However, the law is still far from being clear.

The liability of remote tippees is another dimension that reveals the uncertainty of the prohibition of illegal corporate insider trading. However, the recent judicial developments, particularly the Supreme Court's decision in *Salman,* have brought greater certainty for the U.S. regulations. As for the case of S.A., it is less likely to, at least, be criminally liable in the United States because of her lack of knowledge that the information was disclosed by the inside tipper for personal benefit. However, in Saudi Arabia, it is more likely than not that they would hold S.A. liable for trading on information she likely knew was material and non-public even if she did not know the information was generated from an insider. This probable prediction of the law in this scenario is based on the language of CMA Article (6)(b) of the MCR which prohibits trading after possession of inside information from anyone. This scenario is also grounded on Article (50)(b) which prohibits outsiders from trading on inside information known to be disclosed by *an insider* in violation of his duty not to disclose inside information to others with *the expectation* that they will trade.

S.A. is a sophisticated investor who would have been able to distinguish inside information from mere rumors. In fact, S.A.'s trading was intentional with conscious avoidance since she was aware that the information was specific and unknown to the public. However, if S.A. was not an investment manager but a small investor who did not have enough knowledge or experience in trading securities, would S.A. have known whether the information was inside information when the disclosing person was not an insider or related to an insider? As a result, the requirement in Article (50)(b) that the outsider must know that the inside information originated from an insider is a very important restriction to protect innocent traders. However, Article (6)(b) ignores this restriction and makes sophisticated and unsophisticated investors vulnerable to the same standard of criminal liability.

Conclusion

The comparison in this chapter revealed that Saudi Arabian corporate insider trading regulations agree with the U.S. in three main points. First, Saudi Arabian regulations require public disclosure of securities ownership from corporate insiders, directors, senior executives, and substantial shareholders. Second, Saudi Arabian regulations prohibit corporate insiders from trading on inside information that is available to them because of their fiduciary position. Third, Saudi Arabian regulations also prohibit corporate outsiders from trading on inside information.

However, Saudi Arabian regulations differ from the U.S. on several issues. The regulations do not prohibit insiders from making short-swing profits. It prohibits directors and senior executives from trading during certain lock-up periods. The regulations provide a broader reach for the prohibition of trading on inside information to combat any attempt to trade on inside information in which the trader, corporate insider or not, would possess unfair informational asymmetry: public investors would not be aware of the inside information. This broader prohibition can be described as a disadvantage of the Saudi regulations where broadness brings uncertainty. The Saudi Arabian regulations do not predicate the prohibition of illegal corporate insider trading on construing trading on inside information as a fraud or deception but as a violation of the notion of fairness among investors in having equal access to information. The regulations do not require a breach of a fiduciary-like relationship to find liability. For tipper/tippee liability, Saudi Arabian regulations do not require that the tipper must disclose the information for personal benefit and the requirement of intentional disclosure under Article (50(b) of the CML is uncertain to protect from the prohibition of trading upon tippees. Tippees can be held liable without the need to know whether the source of the information was an insider or not. A negligent violation of the law can be the basis to justify criminal liability.

Chapter 5. Conclusion

The objective of this dissertation is to analyze the current regulations of corporate insider trading in the United States and Saudi Arabia and to examine whether the two countries' laws are doctrinally and practically similar or different. It also seeks to discover the strengths and weaknesses of the Saudi Arabian corporate insider trading regulations by comparing the Saudi Arabian corporate insider trading regulations with the U.S. regulations. Saudi officials can benefit from the well-established and sophisticated U.S. experience of regulating corporate insider trading dating back to the enactment of the SEA in 1934. This dissertation pursues these objectives by answering three general questions in both countries' regulations: (1) Why are corporate insiders subject to rules and duties under securities laws in addition to their basic duties and obligations in corporate laws? (2) When are corporate insiders allowed to trade? and (3) When are they prohibited from trading? The analysis between U.S. and Saudi Arabian corporate insider trading regulations reveals that both countries' regulations share many similarities in the legality question of corporate insider trading and the application of the two sets of regulations. However, uncertainty and confusion are also found in the two countries' regulations although the level of ambiguity is higher for the Saudi Arabian regulations than the U.S. regulations.

Uncertainty in ascertaining the legal rules does not serve the goal of securities laws nor does it help people comply with the law. Corporate insiders play a significant role in fostering the growth and profitability of their corporations. Therefore, encouraging them to own more securities in their corporations is a useful mechanisms to motivate them to accomplish more economic success which, in the end, will benefit shareholders and public investors.[1856] In contrast, corporate insiders are entrusted with the property of their corporations and are given the default right to manage and control the business operation of their companies. Such large powers that come with an opportunity to abuse this right is a reasonable concern for public investors.[1857] The confidence reposed on one of the main players in securities markets, corporate insider may collapse if corporate insiders use confidential information as if they own it and can do with it as they desire for their personal advantage, instead of sharing the information with those who entrusted them, the shareholders.[1858] Consequently, confidence in the whole market may be damaged. However, it is unfair to apply confusing regulations upon the trading activities of corporate insiders. Some balance between the two concerns should be considered: prohibiting unfair informational advantage by corporate insiders and having bright-line rules that protect corporate insiders' right to trade. Such a balance is more evident in the U.S. than Saudi Arabia.

Notwithstanding the absence of written statutory provisions, the U.S. illegal corporate insider trading is defined by the federal courts, particularly the U.S. Supreme Court. Since they have realized the need for some balance between the two concerns, the U.S. Supreme Court has applied two rules to accommodate the two concerns. The first rule is that the liability is not based on the possession of inside information but in a breach of a duty to disclose such information. The second rule is that not every act of selective disclosure to others ensues liability, but liability may be found when the disclosure is made for personal benefit.

[1856] *See* HAZEN, *supra* note 2, at §12:160.
[1857] *See* COLOMBO, *supra* note 11, at §1:1.
[1858] *See LANGEVOORT, supra* note *6, at* §4:7.

In contrast to the U.S. regulations, Saudi Arabian regulations have applied the prohibition more broadly, making the differentiation between legal and illegal corporate insider trading difficult to ascertain. Saudi Arabian legislative experience in governing and regulating securities markets is relatively new, with the first unified securities market law in Saudi Arabia enacted in 2003. Therefore, this dissertation calls for regulators and judges to examine the problems that can result from overly general and broad provisions, as illustrated in this dissertation. This study highlights the need for equilibrium that guarantees investors' confidence in the integrity of securities markets and the right to allow corporate insiders to trade without being vulnerable to uncertain liability. To highlight these issues, this chapter provides a summary of the findings and suggests recommendations for the Saudi Arabian corporate insider trading regulations.

Summary

This dissertation begins with an introduction chapter, Chapter 1, which provides introductory comments about the subject of the dissertation. It provides a definition for the term "corporate insider trading" and lays out the academic debate of whether corporate insider trading should be deregulated or regulated. Finally, this chapter provides an overview of the regulatory framework of U.S. and Saudi Arabian regulations related to securities laws and other sources of laws related to governing corporate insider trading. This chapter defines corporate insider trading as: "the purchase or sale of a stock of a listed corporation in a national exchange by one who has actual or constructive control of the corporation or who has legitimate access to inside information."[1859] It also defines the term inside information as "information that is not publicly known and is only available to

[1859] Chapter 1, What is Corporate Insider Trading? PP. 2.

corporate insiders and others who are bound by confidentiality duty where the disclosure of such information would have materially affected the market price of the traded stock."[1860] This chapter then discusses the legal and economic debate about whether corporate insider trading should be regulated. It concludes that a stronger reason to regulate corporate insider trading is the unfairness attached to allowing insiders to trade without any restrictions. Thus, corporate insiders should be deprived of the opportunity to personally benefit based on inside information when they are under a duty to share the profits from public disclosure of the information with the shareholders.[1861]

The body of the dissertation has three chapters: Chapters 2, 3, and 4. Chapters 2 and 3 are devoted to determining and assessing the regulations of corporate insider trading in the United and Saudi Arabia. Chapter 4 compares the U.S. and Saudi Arabian corporate insider trading regulations with more focus on the practicability of the two countries' laws.

The same basic questions are asked in Chapter 2 concerning U.S. regulations and Chapter 3 concerning Saudi Arabian regulations. The questions are (1) What it is the legal status of corporate insiders? (2) What are the rules and regulations that govern legal corporate insider trading? and (3) What are the regulations governing illegal corporate insider trading and when may corporate insiders be liable?

The first parts of Chapters 2 and 3 discuss the question of the legal status of corporate insiders to clarify the importance of corporate insiders' position and to justify the two countries' securities regulations' approach to regulate corporate insider trading. In particular, part one of Chapter 2 discusses the legal status of corporate insiders in the United States under corporate state law. It reveals that corporate directors, officers, and to some

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[1860] *Id*.
[1861] *See supra* note 77-80 and accompanying text.

extent large shareholders owe a fiduciary duty to the corporation and to the shareholders. While this part finds that there is no inclusive definition of when a fiduciary relationship is established, the analysis of this issue suggests that a fiduciary relationship is established when one person (fiduciary) is entrusted by another person (principal) and where the principal relies on the fiduciary to act in good faith and for the best interest of the principal and to refrain from conflict-of-interest conduct including misusing confidential information for personal benefit unless informed consent is given by the principal. Part 1 of Chapter 3 discusses the same question for Saudi Arabian regulations and shows that corporate directors and officers are subject to a fiduciary duty. A fiduciary includes "any person who is in possession of another's property based on the authorization from its owner or by law."[1862] Corporate directors and managers are under a duty to act within their agency authorization and refrain from acts involving favoritism unless specific consent is given.

The analysis of the fiduciary principle in the two countries' laws shows that this principle is well-established and developed in the United States whether through common law judges or by legal scholars. The concept has been developed even further at the federal level under the law of illegal corporate insider trading where the breach of a fiduciary that constitutes non-disclosure of material information in connection with the purchase or sale of a security is recognized as a fraud actionable under federal securities laws. However, the analysis of the fiduciary concept in Saudi Arabia shows that even though Saudi Arabian law, particularly Islamic law, has recognized the fiduciary principle upon corporate insiders and other fiduciaries, the concept of fiduciary duty is still relatively new in terms of its use

[1862] *See supra* note 1264 and accompanying text.

in regulations or governmental enforcement or even in terms of shareholders' awareness about their right to hold directors accountable for their breach of fiduciary duty.

The second parts of Chapters 2 and 3 discuss the regulations directly governing legal corporate insider trading. Part 2 of Chapter 2 discusses Section 16 of the SEA, which is considered the sole statutory provision within the U.S. securities laws that expressly governs corporate insider trading. In particular, this part analyzes the reporting requirements imposed upon corporate insiders, under Section 16(a), and the private civil liability on corporate insiders from gaining short-swing profits resulting from the purchase and sale or sale and purchase of the issuer equity security within a six-month period, under Section 16(b). This part also shows that corporate insiders under Section 16 are the directors, senior officers, and large shareholders who are the beneficial owners of more than 10 percent of the issuer's equity security. Corporate insiders are required to disclose once they become subject to the rule of this section, and at the end of the second business day following the execution of a transaction that results in a change of beneficial ownership. By 45 days from the end of the issuer's fiscal year, they are also required to disclose all trading transactions that were not disclosed or exempted from disclosure. Congress' intent in issuing a private cause of action to the issuer to seek disgorgement of the ill-gotten gains of short-swing profits was to prevent corporate insiders from misusing their trust position by mishandling confidential information for trading on speculative transactions. However, Section 16 does not prohibit corporate insiders from trading on the basis of inside information.

Part 2 of Chapter 3 examines the Saudi Arabian regulations that govern legal corporate insider trading. The analysis of this part reveals that Saudi Arabia requires public disclosure of securities ownership and trading transactions of corporate insiders, under Articles (68) of the ROSCO and (33) of the LR of 2017. Corporate insiders who are subject to public disclosure are directors, senior executives, and substantial shareholders who own or have interest in five percent or more of the issuer's equity security. Corporate insiders are required to disclose once they are in such a capacity, and by the end of the third business day following the date of the execution of a transaction that results in a change of ownership percentage. Within three months following the end of the fiscal year of the issuer, they are also required to disclose their securities ownership and trading transactions during the previous year in the board of director's report. However, the Saudi regulations do not have a similar provision to Section 16(b) of the SEA. The Saudi Arabian regulations impose a different method to prevent corporate insiders from trading at a time they are more likely to be aware of inside information. The regulations impose lock-up periods that prohibit corporate insiders from trading on the issuer's stock during the 15 days before the end of the financial quarter of the issuer until the announcement of the quarterly report and 30 days preceding the end of the fiscal year of the issuer until the public disclosure of the annual report.

The analysis of the public disclosure requirement imposed upon corporate insiders reveals that both regulations have focused in the definition of corporate insiders upon the ability to control the vote or the power to direct the vote of issuer's stock and the stock that is owned indirectly by corporate insiders by having an interest in such stock. In addition, the analysis shows that although public disclosure of the trading transactions of corporate insiders serves as fair notice to the public that a corporate insider is trading and that it will help investors act based on such knowledge, this dissertation argues that the third-day period available to corporate insiders to disclose may not serve the objective of requiring public disclosure. The insider still has three days to trade anonymously and gain profits that they may not have gained if they had disclosed before or simultaneously with their trading transactions. This delayed time of disclosure may add little benefit to public investors.[1863]

The third parts of Chapters 2 and 3 examine the regulations of illegal corporate insider trading in the U.S. and Saudi Arabia. Part 3 of Chapter 2 examines U.S. illegal corporate insider trading by answering three questions: (1) Who is subject to the prohibition? (2) What does material non-public information mean? and (3) What is the requisite state of mind? This part shows that the prohibition of trading on material non-public information is not regulated by express statutory provisions. The law that prohibits this illegal trade is mostly a judge-made law based on the interpretation of the broad language of Section 10(b) of the SEA and Rule 10b-5 that prohibits the use of any deceptive or manipulative device in connection with the purchase or sale of a security.[1864] This examination of the U.S. illegal corporate insider trading law reveals that the reach of the prohibition goes beyond Section 16 corporate insiders. However, the case-law and SEC rules have restricted the reach of the prohibition to persons bound by a fiduciary-like duty of trust and confidence either owed to the other party in a security transaction (classical theory) or to the source of the information (misappropriation theory). This includes

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[1863] *See supra* notes 1376-86 and accompanying text.

[1864] The SEC has issued Rule 14e-3 promulgated under Section 14(e) of the SEA to regulate expressly the trading on material non-public information relating to a tender offer. This prohibition covers any person in possession of material nonpublic information acquired directly or indirectly from the offeror, the target company, or any person acting in behalf of the offeror or the target company. However, this rule is limited to information related a tender offer. For more discussion about this rule, *see supra* notes 646-59, 861-880, and 1092-1109 and accompanying text.

classical corporate insiders, family members, employees, and friends who are entrusted to keep material non-public information confidential.[1865] This part also reveals that federal courts developed a special test for finding liability against tipping by insiders and trading by tippees who do not owe an original duty of trust and confidence. This test restricts the liability of tipping to situations involving disclosing material non-public information in a breach of corporate insiders' fiduciary duty for personal benefit and the tippee knows or has reason to know that the disclosure of the insider was in a breach of his/her fiduciary-like duty of trust and confidence for personal benefit. The recent development of tipper/tippee liability has focused on whether disclosure in the form of a gift to anyone would suffice for the personal benefit test. The analysis of this issue reveals that although the recent Supreme Court's decision in *Salman* does not expressly comment on this argument, in 2017, the Second Circuit, in *Martoma*, found the logic of *Salman* holds: that the disclosure of material non-public information can be in the form of a gift to anyone and, therefore, suffices for the personal benefit test where it is not necessary that the parties share a personal relationship. The Second Circuit found that the disclosure can be made as a gift when the disclosure is made with the expectation that the tippee would trade. This part also shows that the definition of material non-public information was developed based on case-law to mean any information that has been disclosed or is known by the public where its disclosure would be considered by a reasonable investor to have significantly changed the total mix of publicly available information. This part also discusses the requisite state of mind for finding liability of illegal corporate insider trading. The analysis

[1865] *See* the discussion about the SEC's Rule 10b5-2, *supra* notes 629-45 and accompanying text. *See* also a recent judicial development that attempted to find liability based on the deceptive acquisition of material non-public information, *supra* notes 660-83 and accompanying text.

of this element reveals that while the federal courts have provided inconsistent opinions, the SEC has issued Rule 10b5-1 to resolve this debate by triggering the liability based on whether or not the insider is aware of material non-public information when he/she conducts the trade. The analysis of this part shows that although the limit between legal and illegal corporate insider trading is still uncertain, the current law is far more certain than previously. This part discusses that a corporate insider trading can trade legally when: (1) the trade is based on public information and personal assessment or sophisticated knowledge of the insider when the insider is not aware of material non-public information; and (2) when the trade is made in accordance with a previously written trading plan even though the insider becomes aware of material non-public information at the time of the trade.

Part 3 of Chapter 3 discusses Saudi Arabian illegal corporate insider trading regulations by answering the same questions discussed under the U.S. law. The analysis of the Saudi Arabian regulations shows that it regulates the prohibition under Article (50) of the CML which was defined by the CMA within the MCR. This part reveals that the theory of prohibiting corporate insider trading is broad and general and is based on the parity of equal access to information. The prohibition covers traditional corporate insiders and others who are considered under the insider status by obtaining inside information through a family, business, or contractual relationship. The prohibition also covers corporate outsiders who receive inside information and trade while knowing that the information is inside information. This part shows that inside information is defined by Article (50) of the CML. It covers information related to a traded security that has not been disclosed to the public or is not available otherwise, and its disclosure to the general public would significantly affect the price or value of the related security. This dissertation argues that the Saudi Arabian regulations suffer from uncertainty in several aspects, and the boundaries between legal and illegal trading can be difficult to define in some scenarios. First, it is uncertain that legitimate reasons to trade including trading pursuant to written trading plans can shield a corporate insider from liability when the trade is made when the insider could have been aware of inside information. Second, it is unclear and unsolved whether a corporate insider, to be held liable for disclosing inside information, must disclose the information to a corporate outsider with the expectation that the recipient will trade in the information. The third issue that the analysis reveals that is obscure is whether a corporate outsider is required to be held liable if the inside information is received directly or indirectly from an insider. This part concludes that although the distinction between legal and illegal corporate insider trading is not clarified, corporate insider trading is legal when the trade is made at a time the insider is not aware of inside information and not in a lock-up period. The corporate insider should take some precautions to shield him/herself from liability, including reaching out to the management to ascertain whether he/she is allowed to trade. If there is uncertainty, the insider should refrain from trading.

The fourth parts of Chapters 2 and 3 examine the governmental enforcement of illegal corporate insider trading prohibition. Part 4 of Chapter 2 discusses the U.S. governmental enforcement of the prohibition. The discussion reveals that the violation of the prohibition can result in criminal or civil liability or both. The violation must be intentional where negligent violations are not subject to the prohibition. This part shows that the probability of facing civil liability for violating the prohibition is much higher than criminal liability mainly because the standard of proof is lower in civil proceedings than in criminal lawsuits. This part also reveals that the elements of conduct of illegal corporate insider trading can be proven by circumstantial evidence. This part reports that the major civil penalty against violators of the prohibition is a civil monetary penalty of up to three times the amount of ill-gotten gain or loss avoided from the transaction. In addition, the major criminal sanctions include a fine not exceeding $ 5 million for natural persons and imprisonment of more than 20 years. The U.S. regulations also grant contemporaneous traders the right to seek damages against violators of the prohibition of trading on material non-public information.

Part 4 of Chapter 3 discusses the Saudi Arabian governmental enforcement of the prohibition of illegal insider trading. This part reveals that the violation is considered a crime punishable by the highest sanctions available in the CML. This part shows that the standard of proof is flexible where the crime is proven through direct and circumstantial evidence. The major available sanctions against the violation of the prohibition are a ban from working as a director or officer for a listed company for a certain time, disgorgement of ill-gotten gains, a monetary fine not exceeding $26,666, and a prison term up to five years. The analysis of the government enforcement shows that the consequences of being caught for trading on inside information is more severe in the United States than in Saudi Arabia.

Chapter 4 is a comparative analysis between the U.S. and Saudi Arabian corporate insider trading regulations. A hypothetical case involving several persons, insiders and outsiders, and various circumstances is the basis for a comparison of how each country would apply the regulations. The result of the comparison reveals that the Saudi Arabian regulations have the advantage in that Saudi Arabia has regulated corporate insider trading through written provisions describing the prohibited conduct. However, the analysis also reveals that the Saudi Arabian regulations suffer from uncertainty and gaps. The analysis shows that the Saudi Arabian regulations contain a different standard of liability between Article (50) of the CML and the CMA's articles in the MCR, which has made the law obscure. In contrast, although the U.S. prohibition of illegal corporate insider trading lacks a statutory provision, the certainty and the protection from unwarranted liability is far greater than Saudi Arabian regulations. In particular, the U.S. regulations grant corporate insiders an affirmative defense against liability when their trading is based on a written trading plan. The regulations do not cover negligent disclosure of inside information, and tippees liability hinges on whether the tippee knows or has reason to know that the information was disclosed directly or indirectly by an insider in breach of his/her fiduciary duty for personal benefit. The analysis shows that Saudi Arabian regulations do not have a parallel provision similar to the U.S. that grants an affirmative defense for insiders when they trade based on written trading plans made at a time when they are not aware of inside information.

<u>**Recommendations**</u>

Examining the U.S. and Saudi Arabian regulations and comparing the two countries' regulations of corporate insider trading reveals important results that illustrate the need to reform Saudi Arabian regulations. This section proposes recommendations that aim to provide greater certainty in the Saudi Arabian regulations.

a. Adding a New Article Similar to Rule 10b5-1(c)

This dissertation recommends that the CMA adopt a new article that should be included in the MCR that contains parallel language to Rule 10b5-1(c) regarding written a trading plan defense.[1866] Corporate insiders are always presumed to be in possession of confidential information. However, premising illegal corporate insider trading liability on a possession standard imposes an unwarranted burden upon corporate insiders and it may discourage them from trading. The goal of the prohibition is not to discourage insiders from trading but to prevent them from trading based on inside information. Therefore, granting corporate insiders an affirmative defense when the trade is made pursuant to a written trading plan, contract, or instruction to sell or purchase the related security made before the insider becomes aware of inside information will encourage corporate insiders to trade in their companies' stock without being vulnerable to the unwarranted risk of liability.[1867]

b. Alternative Interpretation to the Liability of Disclosing Inside Information and Trading by Outsider Recipients.

The second recommendation is that the CMA should adopt the apparent interpretation of Article (50)(a) regarding the prohibition of disclosing inside information where the unlawful disclosure is predicated on the knowledge or at least the expectation that the recipient will trade on the information.[1868] The concern of the prohibition is that corporate insiders shall not selectively disclose inside information as it is their own property with the goal of facilitating others' trades. Adopting this proposal would provide more certainty to the law in that it would only prohibits intentional acts aimed to disrupt equal access to information by giving unfair informational advantage to some outsiders

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[1866] For more discussion about Rule 10b5-1(c), *see supra* notes 1077-91 and accompanying text.
[1867] *See id*.
[1868] *See supra* notes 1530-47 and accompanying text.

over public investors. However, negligent disclosure should not be a basis for criminal liability where the insider is acting with no culpable intent to violate the law.[1869]

Regarding the liability of outsider recipients of inside information, this dissertation recommends that the CMA reinterpret the phrase "another person" under Article (6)(b) of the MCR.[1870] The new interpretation of the phrase "another person" should mean an insider or another person who receives the information from an insider. Liability should arise when the outsider recipient obtains inside information directly from an insider or indirectly through other persons who originally obtained the information from an insider. In addition, the outsider recipient is aware that the information is disclosed improperly by the insider. This interpretation matches the apparent language of Article (50)(b) of the CML. This proposed interpretation would bring greater certainty to the prohibition so public investors would not be vulnerable to criminal liability when they trade on information thought to have originated from rumors or circulated news. In addition, the restriction of the broad language of Article (6)(b) of the MCR would ensure that only people who know that they are acting on improper and selected disclosure are punished. Investors acting on negligent or innocent intent shall be out of the scope of criminal liability.[1871]

c. Requiring Corporate Insiders to Publicly Disclose their Trading Activities at the Same Time of their Trade.

The final recommendation is that the CMA should amend its current regulation of the ROSCOS, Article (68), to require corporate insiders including directors and senior

[1869] This recommendation is derived from the U.S. recent development of tipper/tippee liability decided by the Second Circuit, in *Martoma*, and the comments of Professor Donald Langevoort. *See supra* notes 813-16 and accompanying text.
[1870] MCR, *supra* note 156, art. 6(b). *See supra* note 1551-93 and accompanying text.
[1871] For more discussion, *see supra notes* 1627-32 and accompanying text.

executives, to file a report with the CMA or the Exchange disclosing their intent to trade in the company's stock at the same time of their trades.[1872] This proposal would help foster transparency and the application of the policy of public disclosure that the CML has sought to apply in the Saudi stock market. Public investors would be given the opportunity to respond to the insider's trade in advance manner by reevaluating their decision of whether to buy or sell the company's stock based on the already available public information and the new development regarding the insider's report to trade. This proposal would also will reduce corporate insiders' profits from trading on inside information since the public investors would be in a better position to react to the insider's trade.[1873]

Contribution to Knowledge

The objectives of this dissertation are to answer three general questions: what are the regulations of corporate insider trading in the United States and Saudi Arabia? Are they similar or different? and How the Saudi Arabian regulations could benefit from the United States' regulations? Since no previous study has systematically examined and compared these two countries' regulations, this dissertation is an important contribution to the extant literature in three aspects. First, to the best of the student's knowledge, this dissertation is the first dissertation to study the subject of corporate insider trading in Saudi Arabia. Second, this dissertation provides a considerable amount of data and discussions about the regulatory provisions, judicial analyses, and the CMA's interpretations including practical issues that are addressed for the first time in a dissertation. While the dissertation describes the regulations of corporate insider trading in Saudi Arabia, the student has attempted to find answers for issues that emerged in the research as unclear or ambiguous in Saudi

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[1872] *See supra notes* 1367-80 and accompanying text.
[1873] This recommendation is derived from Professor Jesse M. Fried. *See Supra* notes 1378-79.

Arabian regulations. For example, could corporate insiders could avoid be liable for trading while in possession of inside information when their trades were not motivated by the possession of such information? Could they be held liable for disclosing inside information even though their disclosure was not for the purpose of facilitating the recipient's trades? Could corporate outsiders be held liable if they trade on inside information obtained from anyone including information obtained inadvertently from an insider?

This dissertation also addresses the issue of public disclosure of corporate insiders' securities ownership and trading transactions in light of the concern of trading on inside information by corporate insiders and how the three days wait after public disclosure policy may hinder to the effort of combating illegal corporate insider trading in Saudi Arabia. In addition to addressing the practical issues that were discussed for the first time, this dissertation offers a theoretical contribution to the literature by endeavoring to define the legal status of corporate insiders in Saudi Arabia and why they are regulated by securities regulations.

Another significant contribution of this dissertation is in regard to the U.S. corporate insider trading regulations. While the U.S. illegal corporate insider trading law is still governed by case-law not by express statutory provisions, this dissertation provides an important contribution to the current body of the literature. It specifically describes the development of the law of illegal corporate insider trading in the United States before and after the enactment of the securities laws in the 1930s until the recent development of the law regarding the tipper/tippee liability, by the U.S. Supreme Court's decision in *Salman*. In addition, this dissertation not only determines the current status of the law but also attempts to explain the justification of the law.

The third and most significant contribution of this dissertation comes from the findings of the comparative analysis between the Saudi Arabian and U.S. corporate insider trading regulations. It is the first dissertation to compare between the two countries' regulations and thus fills a significant gap in legal literature. The use of the hypothetical case to compare between Saudi Arabian and U.S. regulations shows the uniqueness of this dissertation. The use of a hypothetical case has been employed to illustrate when corporate insiders can trade legally and when they are prohibited from trading under each country's regulations and to highlight the similarities and differences between the two countries' regulations. The dissertation uses the results of the comparative analysis to point out to the weaknesses and gaps found in the Saudi Arabian regulations and to make recommendations to reform the Saudi Arabian regulations. This dissertation hopes that the CMA and judges in Saudi Arabia can benefit from this comparative analysis and follow the recommendations to reform the current regulations so they are more certain and to avoid unwarranted conflicting interpretations.

Acknowledgement of Limitations and the Need for Further Research

Corporate insider trading is a broad subject. This dissertation has focused on describing and determining the two countries' regulations of corporate insider trading by answering three specific questions: What is the legal status of corporate insiders and why are they regulated by securities regulations? and What are the regulations governing legal corporate insider trading? and What are the regulations governing illegal corporate insider trading? The lack of previous research that compares the Saudi Arabian regulations with the U.S. regulations necessitated the student to focus more on explaining the foundation and the background of the two countries' regulations of corporate insider trading which affects the dissertation's length. The focus of the comparative analysis conducted on the two countries' regulations was on the legal outcome from the application of each country's regulations and how the uncertainty and contradictory interpretations founded in Saudi Arabia could be resolved by benefiting from the U.S. regulations. However, due to the restrictions of time and limited resources, the student did not address several issues that demand closer examination and further research. First, the dissertation is restricted to only address the Saudi Arabian and U.S. regulations. Therefore, the findings of this dissertation are solely focus on about the differences and similarities between Saudi Arabia and the United States. In addition, the recommendations proposed to reform the Saudi Arabian regulations are proposed based on this understanding. Further research may be conducted to compare the Saudi Arabian regulations with other countries' regulations.

The dissertation has not discussed the issue of the differences of the composition of the stock markets in Saudi Arabia and the United States and how these differences can impact the broadness or limitations of corporate insider trading regulations. Although the dissertation has described the ownership structure in the Saudi stock market, the dissertation has not discussed the ownership structure in the United States nor whom are targeted or are disadvantaged by the regulations whether in Saudi Arabia or the United States. For instance, this dissertation has not discussed the effect of allowing citizens of the countries of the Gulf Cooperation Council to trade on stocks listed in the Saudi stock market[1874] or the impact of the recent opening of the Saudi stock sarket to foreign investors

[1874] See Capital Market Authority, Qarar Majilis Hayyat Al-Suwq Al-Malia Bishan Tatbiq Al-Musawat Al-Attama Bayn Muatinia Dual Majils Altawawn fi Majal Tamlik Al-Ashum Wa Tadawuliha [The decision of the Board of the Capital Market Authority regarding the application of complete equality between the to directly own and trade securities.[1875] The issue herein is whether the CMA has taken the right direction by broadening the scope of the prohibition of illegal corporate insider trading because of the current stock market composition and the absence of judicial mechanisms that could fill the gap in the statutes. In particular, there is no *stare decisis* in Saudi Arabia. Therefore, further research can be conducted to investigate whether the composition of the Saudi stock market in comparison to the United States and the absence of judicial mechanisms to fill any legal gaps, such as making binding precedents as in the United States judicial system, could it suggest that the CMA is right by making the regulations too broad to avoid any legal gaps?

Although the dissertation has partially covered the subject of the governmental enforcement of the prohibition of illegal corporate insider trading, it has not fully addressed the ability of the CMA, compared to the SEC, to enforce the law. The possibility of tracking down violations of illegal corporate insider trading and the foreseeability of charging violators in light of the limited enforcement personnel and limited resources for enforcement. Therefore, further research is needed to focus on studying the governmental enforcement of the prohibition of illegal corporate insider trading in Saudi Arabian with a comparative study with the United States.

The subject of governmental enforcement of illegal corporate insider trading has another dimension that the dissertation has not addressed—the extraterritorial jurisdiction to enforce the regulations of illegal corporate insider trading. This issue is crucial to both

citizens of the GCC countries in the field of securities ownership and trading activities], Sep 24, 2007. https://cma.org.sa/Market/NEWS/Pages/CMA_N343.aspx.

[1875] Ahmed Al Omran & Nikhil Lohade, Saudi Arabia to Open Stock Market to Foreign Investors on June 15, The Wall Street Journal, April 16, 2015, https://www.wsj.com/articles/saudi-arabia-to-open-stock-market-to-foreign-investors-on-june-15-1429191506. Arab News, We Will Encourage more Foreign Investors this year, Says Saudi Capital Market Authority Head, Oct 2, 2017, http://www.arabnews.com/node/1170861/saudi-arabia.

countries. For example, is it possible to enfore local regulations of illegal corporate insider trading against investors who trade on inside information misappropriated outside the territory of the country? In addition, how could the public prosecution use a legal mechanism to indict and adjudicated foreign investors trading unlawfully based on inside information. This issue is a demanding issue for further research. In particular, after the CMA has allowed foreign investors to directly trade in listed companies' stock in Saudi Arabia, possible illegal corporate insider trading can occur by obtaining inside information in the United States and trading in Saudi Arabia or the opposite. In addition, further research can address the possibility that the CMA and SEC can have a cooperation agreement to enforce their local laws against violators of the prohibition of illegal corporate insider trading. Therefore, the investigation and information could be shared between the two regulatory authorities regarding civil and criminal investigations and lawsuits.

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