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Insider Trading: It's Not Just for Suits

By Joel M. Cohen and Mary Kay Dunning

On Sept. 30, 2010, the SEC brought an insider trading case against two railroad employees and their relatives, alleging that the defendants reaped more than $1 million in illegal gains by trading on nonpublic information about the planned takeover of the railroad company. *SEC v. Steffes*, No. 01 Civ. 06266 (N.D. Ill. Sept. 30, 2010). The SEC alleges that the employees traded and tipped on observations made on the job, including seeing people in suits tour the rail yards, hearing coworkers discuss the possible sale of their company, and being asked to prepare asset valuations. Critics complain this is an unfair case of Goliath versus David, where the SEC is going after low-level employees who turned a hunch about the sale of their company into a profit.

The *Steffes* complaint reminds us that the prohibition on insider trading applies to everyone, not just to hedge-fund managers and financiers. The securities laws forbid any transacting party — rich or poor, sophisticated or unsophisticated — with an illegal informational advantage over an unknowing counterparty from making a profit by exploiting that counterparty's ignorance. The rub is the word "illegal," as trading on nonpublic information does not necessarily violate the law.

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This informational advantage often arises where an employee (at any level) learns something through his employment that he is duty-bound to protect. Setting aside the highly fact-specific question of whether information is material — which the SEC will have to prove in the *Steffes* case — the baseline of any insider trading inquiry is whether one who trades on or is tipped about alleged material nonpublic information owes a fiduciary duty to the source of the information to keep it confidential.

A Printer's Imprint on Insider Trading Liability

Remember: it wasn't a hedge-fund manager or master-of-the-universe trader whose case first defined insider trading in terms of fiduciary duty, but rather Vincent Chiarella, a low-level employee of a financial printing firm. In the mid-1970s, Chiarella, an unglamorous "markup man" for the printer, handled five takeover announcements containing code names or blank spaces for the names of acquiring and target corporations. As the *Steffes* defendants allegedly did, Chiarella "observed the suits" at work, deducing the targets' identities. He bought stock in the targets and sold it immediately after the takeovers were announced. Chiarella was indicted on 17 counts of violating § 10(b) of the Securities Exchange Act of 1934. He was tried and convicted on all counts.

Chiarella's conviction was ultimately reversed, but not before the mark-up man left his mark on insider trading jurisprudence. In *Chiarella v. United States*, 445 U.S. 222 (1980), the Supreme Court held that insider trading requires an affirmative duty not to trade on inside information before it is publicly disclosed — a duty that arises from a relationship of trust and confidence between the parties to a transaction. Chiarella worked for the printer, not the targets whose stock he bought, and therefore owed no fiduciary duty to the targets' shareholders. As such, Chiarella could not commit insider trading. The Court outlined the "classical theory" of insider trading: Corporate insiders may not trade on confidential information about the company because they owe a fiduciary duty to the shareholders to keep that information confidential. Three years later, in *Dirks v. SEC*, 463 U.S. 646 (1983), the Court extended liability to those tipped by insiders who owed a fiduciary duty to company shareholders.

Another famous print-shop employee — Anthony Materia — did not fare as well as Chiarella. Materia's job was to read aloud client documents, including draft tender offers, to a proofreader. Like Chiarella, Materia divined the targets' identities, purchased stock in the targets, and sold at substantial gains after the takeovers were announced. In *SEC v. Materia*, 745 F.2d 197 (1984), the Second Circuit filled the gap left by Chiarella, finding that Materia misappropriated nonpublic information in breach of a fiduciary duty owed not to the targets' shareholders but to his own employer, the printer. The *Materia* court embraced the "misappropriation theory" of insider trading, paving the way for its adoption by the Supreme Court 13 years later.

A Lawyer Breaks the Law

The fiduciary duty narrative next turned on the actions of a more traditionally "white-collar" employee, James O'Hagan, a law firm partner. An acquirer retained O'Hagan's firm to handle a takeover. Knowing the takeover target's identity, O'Hagan traded in its stock, reaping $4.3 million after the tender offer announcement. O'Hagan was convicted of 57 counts of securities fraud, mail fraud, and money laundering, and sentenced to 41 months in prison, but not before the lawyer made an impact on the fiduciary-duty requirement. In *United States v. O'Hagan*, 521 U.S. 642 (1997), the Supreme Court endorsed the misappropriation theory, establishing liability for corporate outsiders who misappropriate, and then trade on, inside information in violation of a fiduciary duty owed to the information source, such as an employer.

Are the Railroad Employees Being Railroaded?

The *Steffes* case has prompted some to wonder whether the railroad employees occupied positions high enough within the organization to possess material nonpublic information, or whether they simply traded on a hunch that turned out to be right. Defendant Gary Griffiths worked in a rail yard as a vice president and mechanical engineer of a subsidiary of Florida East Coast Industries, Inc. ("FECI"), and his nephew, defendant Cliff Steffes, worked as a trainman in another rail yard. Both defendants allegedly signed FECI's Code of Conduct prohibiting them from trading or tipping in FECI securities if they possessed material nonpublic information about FECI, including merger or acquisition information.

According to the SEC, once FECI put itself in play, several bidders met with FECI management and toured FECI properties, including the rail yards where Griffiths and Steffes worked. The SEC claims Griffiths knew about the sale because the CFO asked him for asset valuations, he noticed an unusually high number of rail yard tours, and employees questioned him about a possible takeover. Likewise, Steffes noticed an uptick in tours by people in business attire, and his co-workers were discussing the possible sale.

Steffes allegedly purchased FECI call option contracts in an amount equal to his net worth and sold them after the takeover announcement, making a 350% profit. Steffes and Griffiths also allegedly tipped Steffes's father, brothers, and another uncle, who settled with the SEC at the end of October for $225,000. Collectively, the tippees netted more than $1 million in gains.

Has the SEC Gone Off the Tracks?

Some commentators suggest it is unfair to punish these employees for being observant on the job, putting two and two together, and happening to be right. Others wonder how they could access material nonpublic information in the first place, since they didn't work in management, finance, or other departments that routinely receive confidential information. Of course, what they knew goes to the issue of materiality, and it will be worth keeping a close eye on this case to see whether the SEC can adduce enough evidence of materiality.

What's gotten lost in the outrage over this case is that the duty allegations break no new ground. The defendants allegedly signed codes of conduct, vowing to preserve the confidentiality of information learned during their employment and uphold their fiduciary duties to FECI shareholders. Through their jobs, they allegedly gained an informational advantage over other shareholders and used it to their benefit when they traded and tipped. Whether they actually knew anything material about the takeover is another story, to be proven by the SEC.

The duty requirement gives structure to the insider trading offense, which is not defined by statute and developed only through case law. The Supreme Court decided 30 years ago to frame the offense in terms of fiduciary duty, which is one of the only bright lines left in the offense. The Court twice rejected the argument that all market participants must have equal access to information, reaffirming each time that a fiduciary duty — plus a corresponding breach — gives rise to liability. In recent years, however, the case law has strayed from the fiduciary-duty requirement and toward a general duty to refrain from trading while possessing any kind of material nonpublic information, despite Supreme Court guidance to the contrary. Two recent high-profile cases demonstrate this. The Second Circuit in *SEC v. Dorozhko*, 574 F.3d 42 (2d Cir. 2009), ruled that a computer hacker who traded on inside information illegally obtained over the Internet was liable even though he had no relation — fiduciary or otherwise — with anyone having an interest in the stock. The Fifth Circuit recently posited in *SEC v. Cuban*, 620 F.3d 551 (5th Cir. 2010), that an agreement not to trade might satisfy the duty requirement so that a traditional fiduciary duty may no longer be required. Does this mean that breach of contract could become a crime?

Back to Basics

Unlike *Dorozhko* and *Cuban*, the *Steffes* case represents insider trading's return to its roots. The fact pattern evokes Vincent Chiarella in his print shop connecting the dots and trading ahead of acquisition announcements. Whether the facts will develop as pled by the SEC remains to be seen, but the fiduciary-duty allegations seem solid.

The *Steffes* case reminds us that the SEC must regulate all market activity and investigate allegations of information misuse by anyone, whether he hails from Wall Street or Main Street. For those who follow insider trading jurisprudence closely, *Steffes* is business as usual.