SEC HISTORICAL SOCIETY
Transcript of May 22, 2007 Fireside Chat
INSIDER TRADING

THERESA GABALDON: Good afternoon, and welcome to this month's Fireside Chat presented by the Securities and Exchange Commission Historical Society on www.sechistorical.org. I am Theresa Gabaldon, Lyle T Alverson Professor of Law at The George Washington University School of Law and moderator of the Fireside Chats. As our listeners may know, the SEC Historical Society preserves and shares the history of the U.S. Securities and Exchange Commission and of the securities industry through its virtual museum and archive at www.sechistorical.org. The museum's collections of over 2000 primary materials, not easily available through other online sources, are free and accessible worldwide at all times. The virtual museum and archive as well as the Society are separate and independent of the SEC and receive no federal funding. We thank ASECA - The Association of SEC Alumni, Inc. and Pfizer Inc. for their generous sponsorship of the 2007 Fireside Chat season. Their support, along with gifts and grants for many other institutions and individuals are helping to make possible the growth and outreach of the virtual museum this year.

Today's Fireside Chat looks at Insider Trading. During last month's chat on Courts and the SEC, Mark Kreitman of the SEC Division of Enforcement termed insider trading "the capital crime of securities regulation." This afternoon, Mark Radke of LeBoeuf Lamb Greene & MacRae LLP, a former Chief of Staff to SEC Chairman Harvey Pitt; and Donna Nagy, C. Ben Dutton Professor of Law at the Indiana University School of Law – Bloomington, will share with us their insights on why insider trading is so regarded yet still persists.

After the chat, you are invited to visit "Fair to All People: The SEC and the Regulation of Insider Trading." This gallery in the virtual museum and archive looks at insider trading from the early 20th century to the present. The gallery reminds us that insider trading by no means began with Ivan Boesky, Dennis Levine, and Michael Milken in the 1980s. Our chat will become part of the gallery after this broadcast.

The remarks made today are solely those of the speakers and are not representative of the Society. Our speakers can not give legal or investment advice. Donna and Mark welcome.

THERESA GABALDON: There are whole courses offered on insider trading, so we will never be able to cover all of its aspects today. So I think it would be a good idea to start with a little background. Donna, what do you mean when we refer to insider trading?

DONNA NAGY: Broadly defined, insider trading involves purchasing or selling securities on the basis of material nonpublic information. Now, that would be a very broad definition, and not all instances of trading under that definition would actually be illegal. SEC Rule 10b-5 prohibits fraud "in connection with the purchase or sale of a security." And insider trading, at least here in the United States, is considered to be a fraud under certain circumstances.

THERESA GABALDON: Mark, Donna alluded to Rule 10b-5. Are there any other statues or rules of concern when you are thinking about this area?

MARK RADKE: There are some specific rules having to do with the tender offer context, 14e-3 specifically, and in general the provisions against insider trading contained in 10b-5 jurisprudence are only a small portion of a much larger rule of 10b-5 jurisprudence. Notions in cases that are Rule 10b-5 cases but have nothing to do with insider trading often get imported into the law of insider trading. And finally the SEC and rule making after many years of avoiding more specific rule making in 10b-5 offered two rules – 10b5 1 and 2 - to define by rulemaking certain specifics with respect to questions that the courts really left unanswered. We see in the practice today probably more robust jurisprudence than at any time in the past. It's cumulative, so that's not surprising. But I think it's instructive to look back at how much of this grew from pretty slim roots.

THERESA GABALDON: When was insider trading first prosecuted under the Federal securities laws?

DONNA NAGY: The first prosecution of insider trading in a stock market transaction was In Re Cady, Roberts, which was an administrative proceeding initiated by the Securities and Exchange Commission in 1961. Prior to that, insider trading was viewed primarily as a state law issue and a type of fraud in a minority of jurisdictions in the states. Certainly after Rule 10b-5, in the early 1940s, there were a few district court opinions that used Rule 10b-5 in a private right of action context. But those were one-on-one transactions where a director would be dealing in a face-to-face transaction with a shareholder of the corporation. The monumental shift was in 1961 when we see the SEC bringing the first enforcement action for "anonymous" securities trading over a stock exchange. The first criminal prosecution of insider trading was in 1980 and that was the case United States v. Chiarella.

THERESA GABALDON: When do you think that insider trading really first entered the public's consciousness?

MARK RADKE: I think that the historical answer probably lies in a broader definition of market manipulation than we have today. The evils of the 1920s that led to the Securities Acts certainly included insider trading as we know it today. I think the framers of the '33 and '34 Acts believed they had captured the problem and done away with it and how they approach market manipulation and they were as it turned out wrong. A fun historical fact that sort of underscores that is the need for Rule 10b-5 itself, where someone looked around and realized that there was good statutory authority to prosecute under Section 17A of the Securities Act - misstatements made in connection with the offered sale of a security - but they had the anomaly situation of a fellow that was running around, badmouthing to the world the state of affairs at his company in order to induce people to sell him stocks. This would be fraud in connection with his purchases and no one was quite sure that they could cover it under the statues. They adopted Rule 10b-5. I think that one of the great strengths, traditionally has been the flexibility of that rule, not very well defined, implemented judicially with a great deal of ability to redefine itself to whatever the current situation requires. Insider trading is really a reflection of how robust our markets are and so the type of fraud covered somewhat changes over time. I am agreeing with Mark Kreitman; this is the capital crime of the securities law. I would say that the way in which the criminals dress up perhaps changes overtime.

DONNA NAGY: During the mid 1980s, then-U.S. Attorney Rudy Giuliani had several high profile prosecutions involving Wall Street traders and investment bankers. As Mark pointed out, insider trading and market manipulation were much in the papers during those time periods.   Names like Ivan Boesky, and Dennis Levine, and Michael Milken began to make insider trading and market manipulation household topics because of the publicity that was begin generated through these high profile prosecutions. We also had at that time the movie *Wall Street* directed by Oliver Stone, with Charlie Sheen and Martin Sheen, and I think even Daryl Hannah had a role in it.   Insider trading formed a sub- plot in that movie. Michael Douglas was the corporate raider using inside information. So, insider trading began to be talked about in the pop culture. That sensitized many people, not on Wall Street, to the fact that insider trading can be a crime. One can go to jail - Charlie Sheen was led out in handcuffs in the film.

THERESA GABALDON: Mark indicated that insider trading was seen as an evil in the 1920s and obviously a lot of publicity that we saw in the 80s was not flattering publicity. Yet at the same time, we were actually hearing from some economists that insider trading isn't so bad and it could even be a good thing. Could you explain that line of argument?

MARK RADKE: This would be an extension of the traditional Chicago school that would say any information barrier created distorts perfect markets and the information barrier created is the inability of the insider to trade freely on whatever information they might have about a corporation. Good theory I think in practice. The fundamental flaw in that theory is that the markets would retain their liquidity in-depth if everyone would still participate in them. I think the flaw is that if people believed some in the markets had these kinds of advantages of information over the rest of us, people would no longer trade in the markets. I think one of the reasons the U.S. markets have been consistently very solid and very deep in terms of liquidity is that the man on the street, the woman on the street, feels that their investment is given a fair shake and it's subject to regulation so that people are not taking advantage of information in equities. And I think that's where Henry [Manne] and others are really fall apart.

DONNA NAGY: And we can go back even before that to the 60s. Henry Manne, who was later a Dean of George Mason Law School, had authored articles and books in defense of insider trading. He was not only arguing from a stock market efficiency standpoint. He was also arguing that insider trading is an effective means of compensating managers and entrepreneurs for their original and innovative ideas. To encourage that type of risk taking, to encourage that type of innovation, we should let these individuals trade on their ideas.

THERESA GABALDON: Even simpler than stock options?

DONNA NAGY: Some might say pretty close to today's stock options.

THERESA GABALDON: You hear, quite a bit from time-to-time, about various theories of insider trading, what does that mean and what are the main theories?

DONNA NAGY: I mentioned before that not all instances of insider trading, under a broad definition, would be illegal. Basically there are two theories of insider trading: the classical theory and the misappropriation theory. The classical theory of insider trading looks at the relationship between the person who is purchasing or selling the securities on the basis of inside information, and the individuals that he or she is transacting with in the securities market. It gets its classical or traditional name because initially it was focused on what we can think of as true corporate insiders: officers, directors, employees of a corporation who learn corporate information and who owe fiduciary duties of trust and confidence to the corporation and to the shareholders of the corporation. The idea of the classical theory is that when such corporate insiders trade on the basis of material nonpublic information, they are defrauding the individuals on the other side of the transaction. They are being silent about important corporate events unknown to the corporation's shareholders. And in the context of a fiduciary relationship, that silence constitutes fraud "in connection with the purchase or sale" of a security. So, key under the classical theory is the relationship between the trader and the shareholders when the trade is being made. It was extended later to constructive insiders such as lawyers, accountants and other individuals who are in a temporary contractual relationship with the corporation. Those types of insiders, broadly defined, have also been covered under the classical theory.

The classical theory was extended further to include the so-called tippees of true insiders or constructive insiders: individuals who received material nonpublic information from an insider in breach of a fiduciary duty. A tippee would be liable for violating Rule 10b-5 if the insider conveyed that information for a personal benefit. We see the classical theory from Chiarella v. United States, which was decided by the Supreme Court in 1980 and then we see the extension of the classical theory in Dirks v. SEC, which was decided by the Supreme Court in 1983.

So that's essentially the classical theory. The classical theory though does not capture a number of instances of insider trading that are considered to be very detrimental to securities markets. One area that's not captured is so-called outsider trading, when you have an individual who learns material nonpublic information but doesn't get that information from an insider who owes fiduciary duties to the shareholders of the corporation. One instance would be the Chiarella case. Vincent Chiarella was a financial printer. He was printing secret tender offer documents for the acquiring company in a number of takeovers, and he purchased stock in the target companies. So he did not fit the classical paradigm because he was a virtual stranger to the shareholders on the other side of the transaction. And even though it was not made applicable in the Chiarella case - because it wasn't presented to the jury - after Chiarella, we saw the Securities and Exchange Commission begin to bring cases under a so-called misappropriation theory. The misappropriation theory, a complement to the classical theory, looks at the relationship between the insider trader and the source of the information. So the theory of the fraud in a misappropriation case is different from the classical theory. Rule 10b-5 prohibits fraud "in connection with the purchase or sale of a security. The "fraud" in a misappropriation case occurs when an individual secretly uses confidential information for his or own personal benefit in violation of a fiduciary duty owed to the source of the information.

THERESA GABALDON: Have there have been extensions of misappropriation theory to tippees?

DONNA NAGY: Yes. The Supreme Court endorsed the misappropriation theory in 1997 in the case of United States v. O'Hagan. That case involved a lawyer who was purchasing securities in a target corporation; he and his law firm were representing the acquiring company. That case did not involved tippee trading at all. But a host of circuit court cases have upheld tippee liability in the misappropriation context.

MARK RADKE: Let me just weigh in for a moment to make sure our audience understands the need for the misappropriation theory. We have situations where a very significant corporate event is going to occur and is not publicly known, typically a merger or takeover in which there is a bidder or the acquiring company and a target. The stock of the target is likely to be the most volatile as a result of the merger, or the takeover bid. The good example of that is the recent run up we saw in Dow Jones when Mr. Murdoch on behalf of News Corporation announced a $5 billion bid that was going to be 65% greater than the current market price. The problem under the classical theory was that the relationship that was viewed as where the duty ran between the person doing the bad thing, the insider trading and the place where they got the information was duty owed to the corporation in whose shares their trade was made in our takeover situation. That would mean the information source would be the target corporation and the duty owed would be between people that were beholden to the target corporation in some way. Unfortunately the economics work out exactly the opposite. Vincent Chiarella was a friendly financial printer who figured out from documents he was reviewing who the targets were worked for the acquire or the bidder and misappropriated, stole the information from the bidder but used it to acquire shares of the target. That's where the classical theory broke down and where the Burger court needed to create the bridge. What is a little bit troubling as we extend how and where we always have aggressive and creative uses of the law by the staff, perhaps sometimes, subject to a little bit of colder scrutiny by the circuit courts, is that the true fraud is distant from the actual act of acquiring the shares, and that is because the source of information is no longer the target corporation. So when you think about where we have come, insider trading theory gets very interesting. It's also kind of a phenomenon of a harder market in the 80s that saw lot of developments in insider trading theory in part because we had a great bull market and there were a lot of mergers and takeovers, the 90s a little less so. Today as we are seeing market highs, insider trading is back and I am not sure that the theories get pushed a lot but the frequency is certainly up.

THERESA GABALDON: That makes a lot of sense. I would like to test ride for a couple of minutes here. Donna, let's suppose that you get on a airplane and reach in the seat pocket and pull out a folder containing nonpublic information about a new life saving drug to be manufactured by one of the big drug companies and it stands to reason that probably was left there by an insider who work for drug company. Can you trade on that information?

DONNA NAGY: Yes. Basically because again we have to ask ourselves whether the person who reached into the pocket with the information would be engaging in a securities transaction in violation of Rule 10b-5. In other words, is his use of the information a fraud "in connection with the purchase or sale" of a security? To answer that question, we have to run that hypothetical through both the classical theory and the misappropriation theory. The classical theory asks the question, does the person who found this information owe a fiduciary duty to the shareholders of the big drug company? Now, if that person is a complete stranger, the answer is no. And without the fiduciary duty owed to the big drug company and without the fiduciary duty owed to the shareholders of the big drug company, one is indeed free to trade on that information and is not violating Rule 10b-5. Under the misappropriation theory we ask ourselves the question - who is the source of the information? In that case, it's a question mark, who exactly is the source of the information? The information was no doubt derived from insiders at the big drug company. But does the person who found the information owe a fiduciary duty to the source of the information? And once again, the answer here would be no, if that person is a stranger. So the misappropriation theory does not capture that type of conduct. And this goes to the limitations of Rule 10b-5. Rule 10b-5 prohibits most instances of trading on the basis of material nonpublic information. But because both the classical theory and the misappropriation theory revolve around the existence of a fiduciary duty, some acts of insider trading are not captured under either theory. Now it's very important to your question that the information pertain to the development of a new drug.

THERESA GABALDON: Shift in a little bit and point this to Mark instead. Suppose instead of information about new life saving drug, you pulled out information about one company's plans to make a tender offer for another. It stands to reason that the information was left there by someone who worked for the prospective acquirer. Can you trade?

MARK RADKE: There the answer would be, no. Tender offer would take over context was viewed a little bit differently. I think probably because of the market moving significance of the information and the inherent unfairness of allowing what seems to us to be an unreasonable result in the case of finding the information on the airplane and going out and being able to buy stock in a drug company just because somebody happened a misplaced their file on the new life saving drug. Well that doesn't happen often while the amount that issue is may or may not be significant what was happening frequently in the market. What was significant to the enforcers was the leakage of tender offer information in advance of the announcements of the tender offer. Academics were able to chart this. In fact it was rather troubling to see a tick up in the trading price of the stock of the target company in advance of the market announcement and part of the result of that was to enact a specific rule covering this type of conduct that was broader than the more traditional 10b-5 rules that cover all other forms of insider trading.

DONNA NAGY: The SEC had that flexibility in the tender offer context. That is, it promulgated a broader rule - effectively a "parity" of information type rule - because the authority under which the SEC promulgated Rule 14e-3 is Section 14(e) of the Exchange Act. Section 14(e) is a congressional provision that allows the SEC to make rules in connection with tender offers. It also prohibits fraud in connection with tender offers and allows the SEC to promulgate prophylactic rules designed to prevent fraud in tender offers. So Rule 14e-3 can cover acts that are not themselves fraudulent as long as the prohibition of those acts are reasonably designed to prohibit fraud in the tender offer context. And that's different and broader than the SEC's rulemaking authority for Rule 10b-5, which is under the congressional provisions of Section 10(b) of the Exchange Act - limited to fraudulent, deceptive and manipulative acts.

Going back to your question involving the confidential information about the drug company, I was answering the very legalistic question of whether the classical theory or the misappropriation theory covered that type of trading. The question of whether it is legal to trade is very different from the question of whether it is ethical to trade or it is fair to trade. With those different questions, you may come up with different answers. Rule 10b-5 only stretches so far, but perhaps ethics and morals stretch further. Suppose an associate in a law firm finds that confidential information on the drug company. Even if such trading is technically legal, that law firm associate could well immerse him or herself in an investigation, which, while prevailing at the end, could certainly bring some embarrassment to the associate and the firm. So I think there are certainly issues of propriety and ethics that need to be thought about.

THERESA GABALDON: Duly noted.

MARK RADKE: And I think that really centers on what you touched on about parity of information, if you asked the lay person from a pure standpoint of fairness what the rule should be in the ideal rule world, how do you outlaw a bad thing that will define however, you want to define and will call it insider trading. Most people would come up with rules that look like rules requiring parity of information that is to say in a fair market place, both the buyer and seller should know the same information about that which they are buying and selling. There should not being an unfair advantage given to one side or the other and that is not the law, and the fact that through lack of ability to extend what's already a very well extended Rule 10b-5 due to limitations in the statute or the lack of congregational mandate more generally or perhaps good grounding and economies that says maybe we have to stop short of parity of information all of that results in an uneasiness, a certain uneasiness among all of us in the profession and trying to defend how the demarcations are laid out because I think no one would feel that just finding by chance the information on a new breakthrough drug from a drug company should be fairly used against everyone else in the market. And since everyone now is in the market to some certain whether directly or through mutual funds or some retirement funds, that is very palpable concern of most in the public.

THERESA GABALDON: Somehow this conversation makes me start thinking about Martha Stewart probably because she was a high profile defendant in the recent past. We know that she was convicted of obstructing justice, not insider trading. Donna, could you tell us a little bit about what was going on in that case?

DONNA NAGY: That took place in December 2001. So we are going back a while here. Martha Stewart sold all of her shares in ImClone Systems Corporation, a drug manufacturer. She allegedly sold those shares after her securities broker, Peter Bacanovic, through his assistant told her that ImClone's CEO and President Dr. Sam Waksal was trying to sell his ImClone stock. So, lots of people and lots of involvement. I believe that when the Securities and Exchange Commission initially began the investigation, its theory was that perhaps Dr. Waksal shared confidential information directly with Martha Stewart - information that the FDA was about to issue a negative letter on a drug being developed, which was going to send the price of ImClone stock downward. Dr. Waksal knew that information and I believe pleaded guilty for insider trading. Now as the SEC continued its investigation, it learned that Martha Stewart spoke to the doctor only after she had sold off her shares. So this initial theory that there was somehow inside information from the doctor to Martha Stewart did not pan out.

However, it was clear that Martha Stewart did sell all of her shares of stock and SEC investigators learned that indeed she did have multiple conversations with her broker's assistant. Now her broker was the same broker for the doctor, but the broker did not know the negative news about ImClone. What he did know is that the doctor and his family were selling substantial portions of their shares. Martha Stewart sold all of her stock in ImClone and I believe avoided a loss of about $45,000.

THERESA GABALDON: Mark assuming that someone in Martha Stewart's position did learn from her broker that another client of the broker was selling off their shares of the company, which they were likely to have relative information. Is there some theory of inside trading that might stand out?

MARK RADKE: I think the some of this traces back to the confusion left in the wake of the Dirks's decision as to what is information that you gain from the insider and what is information that you piece together from your general knowledge of the market, from your ability to deduce based on your experience. I would certainly argue that the push from the enforcement perspective would be to characterize whatever the information is learnt from the broker about the trading of the individual who is the insider as more keen to actual delivery of inside information. In other words, that which can only be learnt from the insider and is somehow a proprietary to the corporation as apposed to more generic market related information. I don't know what all the events were in Martha Stewart's case but you would look at the nature of the shares sold was under some kind of company trading plan. Did he have some obligation for a quiet period? Was he in violation about obligation? Did the company direct him to only trade through a broker? Did he have some kind of pre-clearance arrangement? Did he violated the company? Something that somehow tripped that insider into having more of a duty than he fulfilled and in breaking that duty, make the person then will receive the information somehow a tippee who should have knowing that the information they were getting could only have come from an insider.

DONNA NAGY: And I think this goes to the point Mark made before in terms of the elasticity of Rule 10b-5 and the misappropriation theory - because the SEC settled the case eventually against Martha Stewart. So the SEC's theory of insider trading never had to be tested in court. Another possible line of prosecuting as a civil offense of Rule 10b-5 would be to look at this as a misappropriation case, the misappropriater being the broker Peter Bacanovic. The idea here would be that client trading information is confidential information. With a duty of confidentiality being owed to the client, and that would be Dr. Waksal, as well as to Merrill Lynch, which was the broker's employer. And so the theory here would be that broker violated Rule 10b-5 when he allegedly took, stole or misappropriated the confidential client information about the Waksals' trading and shared that with Martha Stewart. Now then the question would be whether Martha Stewart violated Rule 10b-5 under the misappropriation theory and there we would ask the question whether or not Martha Stewart participated in her broker's alleged breach of the fiduciary duty owed to Merrill Lynch. The SEC's complaint against Martha Stewart as I mentioned was settled, but the SEC did bring out the fact that Martha Stewart was, long before she was a celebrity on television, a securities broker. So certainly the idea that her broker owed a duty of confidentiality to Merrill Lynch would not have been new to her. And therefore she could reasonably be expected – "should have known" - to use the language that Mark did before - that her broker's telling her of Dr. Waksal's sale plan violated his fiduciary duty. Thus, she could be thought of as a co-participant in the broker's breach of fiduciary duty under the misappropriation theory.

THERESA GABALDON: Obviously, there are lots of other cases with very interesting facts; do you each have any personal favorites?

MARK RADKE: I have always liked the Oklahoma exception to the securities law, which is if you are the coach of the University of Oklahoma and you are in your home state, the technicalities of Rule 10b-5 sometimes might not apply. This was the case in which at a football game allegedly this coach of Oklahoma University received inside information. I believe the testimony was he leaned back and overheard a conversation among others.

THERESA GABALDON: Donna?

DONNA NAGY: That's always a good one. I must say, I enjoy talking to my Corporations and Securities classes about the insider trading involved there. Another favorite would be the Vincent Chiarella financial printer case. I find this an interesting one, first because it was the first criminal prosecution under Rule 10b-5 and unlike in the later 1980s when insider trading captures the images of the Boesky's, and the Milken's and the Levine's, Chiarella was a financial printer back in the days before computers - where a company actually sent documents out to be printed. Chiarella managed to decipher the code names of target companies in order to purchase securities. He settled the case with the Securities and Exchange Commission and then was brought up on criminal charges and litigated that case all the way to the Supreme Court. I think it's an interesting case because he was the everyday common man, and thus doesn't have quite the cachet or the glamour of Wall Street, but I think it stands as a reminder that the Securities and Exchange Commission and the Department of Justice take insider trading very seriously and the stakes are really high. You don't have to be a Wall Street arbitrageur in order to bump into Rule 10b-5 and find that you have violated the law. Chiarella stands as a reminder to all of that.

THERESA GABALDON: One of my favorites and unfortunately I don't remember the name of the case involved, involved a mistress of a businessman. It turned out that she wasn't just the mistress of a single businessman but of multiple businessmen. As the facts of that were splashed across the newspapers. I was thinking about the far reaching implications of what was going on.

DONNA NAGY: Often in these cases, confidential information is learned in the course of family relationships and so these cases often involve husband against wife and mother against son - individuals who think they are entrusting their loved one with confidential information. Probably their lips were moving a little faster than maybe they should have been, but they do so under the belief that their trusted loved one is going to keep that information secret. When a trusted loved one actually goes out and trades on the information, lives are affected in all sorts of different ways.

MARK RADKE: It's interesting that from either the classic theory or the misappropriation theory standpoint, those family situations create some of the most difficult analytical situations. It's not surprising that the SEC put a patch on this with Rule 10b5-2 to try to make clear that the presumption would be if information were shared with a family member, that together with that sharing of the information went with it a presumption that there was a duty to keep that information confidential. Because the number of cases and the variety of cases, a family member who have immediately gone out and traded when mom or dad says, guess what we are going to sell the place and it's going to happen next Tuesday, trade on that information.

DONNA NAGY: And the fraud in those cases, if we go back to the misappropriation theory, the fraud is that the wife or husband is defrauding the spouse, or the brother is defrauding his sister. And so because the misappropriation theory looks at the relationship between the trader and the source of the information, that fiduciary relationship is going to be key there. The deceived party in that scenario is going to be the family member.   Even though the harm, as Mark pointed before, is a market harm, a shareholder harm. But the Supreme Court has found that as long as the fraud is occurring "in connection with the purchase or sale" of the security, the fraud does not necessarily have to be on the individuals in the securities market who are trading.

THERESA GABALDON: In some of these cases, we've indicated that the inside trader kind of bumps into the inside trading rules as a surprise and in other cases it's rather more obvious that there are some obvious culpability. But in those cases where the person may not have realized that what he or she was doing was illegal, does that matter? This is prompted by a question from a listener: what is scienter and is it relevant in an inside trading case?

DONNA NAGY: Scienter is a mental state evidencing an intent to deceive. The Supreme Court held many years ago that to violate Rule 10b-5, one has to have acted with scienter, the mental intent to defraud.   Circuit courts have recognized that conduct constituting recklessness is sufficient to establish scienter. Thus, for liability to attacb under Rule 10b-5, a defendant must either have intended to commit the fraudulent act or the defendant must have been reckless in failing to recognize the consequences of that act.

MARK RADKE: But then action would be not necessarily to the level of a knowing violation of the law, in other words. What is often times seeing is knowing action but unfortunately ignorance of the technical law that you can meet the standard required under scienter.

DONNA NAGY: Exactly. To be imprisoned for a violation of Rule 10b-5, one would have to commit a "willful" violation, and willfulness is an even higher standard of culpability. But in most insider trading cases, proving intent or proving recklessness is a generally not a stumbling block for the Securities and Exchange Commission. Proving the pre-existing relationship – the breach of fiduciary duty - is often the more complicated question.

MARK RADKE: And the criminal cases are many times the most outrageous examples. I mean, the sort of practical tip to give is that when you are passing bags of cash back and forth among your friends, giving up the proceeds of your trading, you are in a bad position.

THERESA GABALDON: But remember we are not giving any legal advice?

MARK RADKE: Right.

THERESA GABALDON: Difficulties of enforcement necessarily come after difficulties of detection. Any guesses as to how much insider trading goes by undetected?

MARK RADKE: On that one, I am sure, unfortunately, it's more than any of us would like to think occurs. The reason I would say that is there is continuing to this day very suspicious up-ticks in trading prior to major corporate announcements, mergers, takeovers, new drugs, big rise or fall with earnings or other kind of quarterly or annual announcements. However, the sophistication of both the SEC and the NASD with the New York Stock Exchange, soon to become just the NASD, in surveilling what happens in the market has improved dramatically. The SEC as a matter of policy has taken cases against very small traders, as well as very large ones, where profits maybe several thousand dollars or less. They will still apply the full resources of the Enforcement Division to bring those individuals to justice when they figure that out that an improper trade has occurred. Surveillance mechanics have gotten very, very sophisticated.

THERESA GABALDON: Question from another listener: can either of you tell us any more about the specifics of the information technology detection programs? What kinds of things might they be looking for? How might they match possible tippers or tippees?

MARK RADKE: I am kind of analog guy in a digital world, so I am probably the wrong person to give you any in-depth data mining discussion but they have been creative in assembling very substantial databases that include those individuals typically involved in transactions, lawyers, accountants and commercial bankers that assist in major transactions, and the board members of all public companies - where they work and where their home addresses are and what their phone numbers are. With a fairly significant investment over a good number of years, the SEC's market watch program has become really quite sophisticated. I think it's a noteworthy thing to say that this is one of those U.S. government programs that really is the envy of the world. They train regulators from all other countries that have stock markets on how they go about their surveillance because it's just that good.

DONNA NAGY: The brokerage firms have additional obligations from the stock exchanges and the NASD to monitor trading in customer accounts at the brokerage firms. These self-regulatory requirements may even be thought of as the first level of surveillance. The brokerage firms have privately funded - and very accurate and intense - surveillance programs of their own and they work with and share information with the NASD, the New York Stock Exchange and the Securities and Exchange Commission.

MARK RADKE: That's a very good point. The big case that was brought to freeze assets of a couple in Hong Kong who traded in advance of the Murdoch announcement of a takeover attempt on Dow Jones was brought because the brokerage firm discovered the activity and very responsibly reported it very promptly.

DONNA NAGY: I believe that Martha Stewart's trading may have been flagged initially by Merrill Lynch.

THERESA GABALDON: Mark, one of your comments just a couple of minutes ago had to deal with the SEC's training of regulators and other countries. Our focus so far has been on the standards of insider trading in this country. Do either of you have any comments with respect to whether our standards and laws are pretty much in sync with those of the rest of the world?

MARK RADKE: Unfortunately here is a place where despite the fact we operate a global economy, we don't operate with anything near global uniformity in rules. Some countries until quite recently did not even outlaw insider trading. It was viewed as a perquisite of a service on a board of directors. Those days are over but the numbers of significant prosecutions that occur in this country versus all around the world is dramatically disproportionate. The SEC in a typical year might bring between 10% and 15% of the total number of enforcement cases, literally hundreds, of insider trading cases. The rest of the world might bring in a typical year a handful. Obviously there is a sliding scale, you can probably start at the top with Canada and the UK and other regulators that work closely with their market centers. I know recently the SEC Office of International Affairs, in writing in the Harvard Law Review, had proposed a comparability standard for giving credit to other nations and enforcing rules that the SEC enforces here at home. And in those cases unfortunately insider trading is one of the real sticking points because it's not felt that foreign regulation is as robust.

DONNA NAGY: It's very interesting though because, outside of the United States, when countries prohibit insider trading, they've chosen to do so directly, rather than as a sub species of fraud. The countries with developed insider trading regulations have defined insider trading, setting out typically a category of individuals, defining what an insider is, defining tippees of insiders, and then directly prohibiting those persons from trading securities based on confidential information. That's certainly one approach. Every decade there are hearings in Congress and proposed bills in terms of whether the United States should define insider trading. A specific statutory prohibition has not happened. Rule 10b-5 appears to be working. Even though there might be a panel at a Congressional hearing and much paper generated in terms of the advantages of a statutory definition, it seems that Rule 10b-5's anti-fraud provision is what US regulators prefer. But other countries have not traveled down that path. They have a statutory definition and enforce that statutory definition. That said, Mark is absolutely right that internationally, the surveillance techniques, the energy, the time put into prosecuting insider trading is not even a shadow of what we see here in the United States. So while these countries have taken a direct prohibition route, they do not have this sophisticated surveillance methodology that we see here in the United States.

THERESA GABALDON: As you have indicated, Congress has been somewhat tentative about regulating insider trading directly. It has adopted a couple of statutes that sort of sniff around the periphery, including one that created a private right of action for insider trading without defining what inside trading was. I am wondering in general just how significant that provision has been and how significant private rights of action are generally and that will be probably be our closing topic for today as our time went down?

DONNA NAGY: In terms of Congregational legislation, Congress's decision in 1984 to allow the Securities and Exchange Commission to impose a penalty for insider trading was fairly monumental. That allowed the Securities and Exchange Commission to impose a penalty of up to three times the profit made or the loss avoided. And so in terms of Congressional innovation, that treble penalty provision has had a real effect.

In terms of the private right of action, in 1988, Congress gave a private right of action for so-called "contemporaneous traders." Yet, that remedy is seldom used by private plaintiffs, in part because Congress limits the damages in such actions to the individual trader's gain or loss avoided. So certainly the incentive to go after that recovery – let's say in a class action type lawsuit – is very little when the recovery is so small. Congress also provided that any disgorgement paid to the Securities and Exchange Commission would come off the top of the plaintiff's recovery. So there is not much money to be made for contemporaneous traders, and their lawyers bringing those cases privately.

THERESA GABALDON: Mark you get the last word?

MARK RADKE: Well we do see in the wake of raising the standards for pleading class actions in securities litigation, a greater frequency of pledging in connection with a broader fraud.

DONNA NAGY: Absolutely.

THERESA GABALDON: Well Donna and Mark, thank you for your insight into insider trading. I would encourage all listeners if you want to learn more about this subject to visit "Fair to All People: The SEC and the Regulation of Insider Trading," a gallery that can be accessed under the galleries tab in the virtual museum and archive at www.sechistorical.org. This chat will become a permanent part of the gallery. Again we would like to thank ASECA - The Association of SEC Alumni Inc., and Pfizer Inc for sponsoring the Fireside Chats. Today's chat is now archived in audio format in the virtual museum so you can listen again to the discussion at any time. A transcript of the discussion as well as the audio in mp3 format will be accessioned in the Online Programs section in the coming months.

Our Fireside Chats will take a break this summer, but I encourage you to participate in the Society's other online programs all broadcast free of charge on www.sechistorical.org. On Wednesday, June 6th, the SEC Historical Society Annual Meeting, broadcast beginning at 12 noon Eastern Time, will discuss "Beyond Borders: A New Approach to the Regulation of Global Securities Offerings." On Tuesday July 31st, at 3 p.m. Eastern Time, we will broadcasting The Best of NERA . This program will be our fourth annual broadcast of the top presentations from NERA Economic Consulting's Finance, Law and Securities Seminar. This broadcast always features an in-depth look at some of the cutting edge issues of securities regulation. We'll resume the Fireside Chats this fall on Tuesday, September 18th. Please join the Philip Ameen of General Electric Company; Conrad Hewitt, the SEC's Chief Accountant and me as we discuss the accounting aspects of the Foreign Corrupt Practices Act. Thank you again for being with us today.