An analysis of insider trading law in the United States starts with Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated by the Securities and Exchange Commission (SEC or Commission) pursuant to the authority it received under that statute. Indeed, much of the law surrounding insider trading focuses on those provisions. However, the federal securities laws also provide other statutes and regulations that should be considered when analyzing trading in securities by “insiders.” Following is a summary of that broader statutory framework related to insider trading.

1. Exchange Act Section 10(b) and Rule 10b-5

Insider trading law springs from Exchange Act Section 10(b) and Rule 10b-5 thereunder, which are commonly viewed as the principal statutory weapons against securities fraud. Section 10(b) provides:

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 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 Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Rule 10b-5, promulgated by the SEC, further defines the type of conduct that constitutes a “manipulative or deceptive device or contrivance” that is prohibited under Section 10(b). That rule states:

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.

In the chapters that follow, the difficult and complicated application of this statute and rule to the myriad sets of facts that can arise when an insider purchases or sells a security will be further discussed. However, the SEC’s high-level view of these provisions is relatively straightforward: If the purchaser or seller of a security has material non-public information about the security and that person has the requisite duty of trust and confidence as described in Rule 10b-5, he or she must either abstain from executing the transaction or disclose the non-public information to his or her counterparty prior to the transaction. Failing to do so potentially violates all three subparagraphs of Rule 10b-5 and is, therefore, a “manipulative or deceptive device or contrivance” in violation of Exchange Act Section 10(b).

2. Securities Act Section 17(a)

Section 17(a) of the Securities Act of 1933 is commonly viewed as the other primary antifraud provision under the federal securities laws. Drafted a year before Exchange Act Section 10(b) was enacted, it provides similar
prohibitions to those found in Rule 10b-5, but is limited to offers and sales, rather than purchases and sales, of securities. Specifically, Section 17(a) states:

It shall be unlawful for any person in the offer or sale of any securities . . . by the use of any means or instruments of transportation or communication in interstate commerce or by use of the mails, directly or indirectly—

1. to employ any device, scheme, or artifice to defraud, or
2. to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading; or
3. to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

The primary difference between Exchange Act Section 10(b) and Securities Act Section 17(a) is that Section 10(b) prohibits fraudulent conduct in connection with either the purchase or sale of a security, whereas Section 17(a) prohibits fraudulent conduct in connection with the offer or sale of a security. Thus, if an individual with material non-public information illegally sells a security, he or she can be charged with violating both Section 10(b) and Section 17(a). However, if that same individual with material non-public information illegally buys a security, he or she cannot be charged with a violation of Section 17(a) because that statute does not apply to the purchase of a security.

3. Exchange Act Section 14(e) and Rule 14e-3

Despite the seemingly broad nature of the prohibitions of Section 10(b) and Section 17(a), in the decades following their enactments, confusion existed with regard to the application of those provisions to the various factual scenarios that could arise surrounding securities trading in the context of a tender offer. Thus, the SEC looked to clarify the rules related to tender offers and looked to Exchange Act Section 14(e) as the appropriate tool for alleviating any confusion. Section 14(e) provides:

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.

Under the rule-making authority granted by Section 14(e), the Commission enacted Rule 14e-3. Rule 14e-3, intended to make clear the “abstain or disclose” obligation of individuals with knowledge of a tender offer, states:

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 non-public and which he knows or has reason to know has been acquired directly or indirectly 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.

Unlike Section 10(b) and Section 17(a), there is no requirement that the person in possession of information concerning the tender offer have a preexisting relationship of trust and confidence with parties to the tender offer. Rather, anyone with such information can be liable for violating
Section 14(e) unless there is a “parity of information” between both the buyer and seller of the securities.

Section 14(e) and Rule 14e-3 also go further than Section 10(b) and Section 17(a) in imposing liability on “tippers” of information concerning a tender offer. Specifically, Rule 14e-3(d)(1) provides, with limited exceptions, that communicating material non-public information concerning a tender offer to a person without a “need to know” about the tender offer is unlawful if it is reasonably foreseeable that the communication is “likely to result” in illegal trading. Thus, unlike Section 10(b) and Section 17(a), which impose liability on tippers only if illegal trading by downstream tippees actually occurs, Rule 14e-3(d)(1) can, “as a means reasonably designed to prevent” insider trading, impose liability even in the absence of a purchase or sale by a tippee.1

4. Exchange Act Section 20A

In 1988, Congress enacted the Insider Trading and Securities Fraud Enforcement Act. As part of that act, Congress included Exchange Act Section 20A, which expressly provides for a private right of action by contemporaneous traders against anyone trading while in possession of material non-public information in violation of any provision of the Exchange Act. Specifically, Section 20A provides:

Any person who violates any provision of this chapter or the rules or regulations thereunder by purchasing or selling a security while in possession of material, non-public 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.

Although the statute seemingly provides the potential for significant relief to traders in securities where the counterparty violated the Exchange Act, it also significantly limits the damages that the violating counterparty must pay. For example, under Section 20A(b)(1), the insider trader is liable for damages only to the extent that he or she made a profit or avoided a loss in the transaction. Even that amount, under 20A(b)(2), is further diminished

1 17 C.F.R. § 240.14e-3, Rule 14e-3(d)(1).
by any disgorgement that the insider trader is required to pay in any action brought by the SEC based on the same transaction. Thus, from a practical standpoint, private plaintiffs are unlikely to obtain significant relief by bringing an action against an insider trader under Section 20A. For that reason, private plaintiffs are much more likely to bring an action against an insider trader based on the implied rights of action found in Sections 10(b) and 14(e).

5. Exchange Act Section 16(b)

Although it is not, strictly speaking, a “law enforcement tool,” Exchange Act Section 16(b) generally prohibits officers, directors, and 10% shareholders of public companies from obtaining short-swing profits in the companies’ securities. In considering the potential for abuse by individuals in those capacities, “Congress recognized that insiders may have access to information about their corporations not available to the rest of the investing public. By trading on this information, these persons could reap profits at the expense of less well informed investors. In Section 16(b) Congress sought to ‘curb the evils of insider trading [by] . . . taking the profits out of a class of transactions in which the possibility of abuse was believed to be intolerably great.’”

Section 16(b) provides:

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.

Put simply, under Section 16(b), if an officer, director, or 10% shareholder of a public company buys and sells, or sells and buys, securities of that company

---

within a six-month time period, the company may generally recover any 
profits of the individual that resulted from the “matching” trades that oc-
curred within that “short-swing” period. There is no requirement that the 
insider was aware of any material non-public information at the time of 
this trading. Rather, the SEC has noted that a strict liability prophylactic 
approach is appropriate when dealing with short-swing profits. Moreover, 
in order to help assure that Section 16(b) would be effective, the statute 
provides for a shareholder derivative action to be brought if the company 
itself does not seek to recover inappropriate short-swing profits.

Section 16(b) and the rules thereunder provide for various exceptions to 
the prohibition on short-swing profits. For example, transactions between 
a company and its officers and directors;3 bona fide gifts and inheritances;4 
profits resulting from mergers, reclassifications, and consolidations;5 and 
certain transactions involving voting trusts6 may be exempt from the 
general prohibition on short-swing profits under Section 16(b) under 
certain circumstances. However, given the potential for abuse by corporate 
insiders, these exemptions are jealously guarded by the SEC.

6. Regulation FD

In 2000, the SEC adopted Regulation FD (Fair Disclosure) in an attempt 
to address what it believed to be a potential problem with selective dis-

closure. Based on information it had obtained from various sources, the 
Commission was concerned that public company issuers were disclosing 
important non-public information, such as advance warnings of earnings 
results, to securities analysts and/or selected institutional investors before 
making that same information available to the general public. Although 
the Commission felt that such disclosure was closely analogous to illegal 
“tipping,” the law concerning the legality of selective disclosure by issuers 
was less developed than that for “standard” insider trading. Thus, the SEC 
promulgated Regulation FD, which provides:

   a. Whenever an issuer, or any person acting on its behalf, discloses 
      any material non-public information regarding that issuer or its

3 17 C.F.R. § 240.16b, Rule 16b-3.
4 17 C.F.R. § 240.16b, Rule 16b-5.
5 17 C.F.R. § 240.16b, Rule 16b-7.
6 17 C.F.R. § 240.16b, Rule 16b-8.
securities to any person described in paragraph (b)(1) of this section, the issuer shall make public disclosure of that information as provided in § 243.101(e):

1. Simultaneously, in the case of an intentional disclosure; and
2. Promptly, in the case of a non-intentional disclosure.

Paragraph (b)(1) of Regulation FD prohibits selective disclosure to any person who is a broker or dealer or person associated with a broker or dealer, an investment adviser, an investment company, or a holder of the company’s securities “under circumstances in which it is reasonably foreseeable that the person will purchase or sell the issuer’s securities on the basis of the information.”

Similar to Exchange Act Section 14(e), liability for violating Regulation FD does not require that the recipient of the material non-public information trade on the basis of or while in possession of the information. Rather, the prophylactic nature of Regulation FD prohibits the selective disclosure of information regardless of whether any trading subsequently occurs.

7. Federal Criminal Law

Insider trading can be prosecuted under the criminal provisions of Sections 10(b) and 14(e) of the 1934 Act, under Section 17(a) of the 1933 Act, and under federal laws prohibiting mail fraud, wire fraud, and securities fraud. Defendants have also been charged with and convicted for aiding and abetting violations of these laws or conspiracy to violate these laws. Securities fraud is not a predicate offense for federal racketeering under the Racketeer Influenced and Corrupt Organizations (RICO)

---

7 Regulation FD excludes from this prohibition information that is provided to an individual who owes a duty of trust or confidence to the issuer, a person who expressly agrees to maintain the disclosed information in confidence, or a person who is involved in certain registered offerings of the issuer's securities.

Act, but mail fraud and wire fraud are RICO predicate offenses. The SEC does not have criminal enforcement authority. All federal criminal cases are brought by the U.S. Department of Justice, usually by one of its U.S. Attorney’s offices located around the country. For many decades, the U.S. Attorney’s Office for the Southern District of New York has taken the lead in prosecuting insider trading offenses.