



## **Insider Trading Law and Prevention**

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### **I. Definition of Insider Trading**

Insider trading occurs if you know material confidential information about a public company (whether it is your company or another company) and you trade on that information or tip others about it before the information is released publicly. Material information is news that can affect a company's stock price, such as knowledge of a takeover or accounting problems, a dividend change, a new product, or earnings that are better or worse than expected.

### **II. Insider Trading Is Illegal for More than Executives or "Insiders"**

This anti-fraud rule does not apply only to company insiders, employees, or executives. The prohibition applies to you, your business associates, your family members, and your friends-anyone who possesses material non-public information at the time of the trade or tip. This insider trading prohibition is separate from the Section 16 rules under the securities laws and the related filings on Forms 3, 4, and 5 made by senior executives and directors.

The publicity surrounding cases involving rank-and-file employees sends a strong message to the financial markets about how no one is outside the SEC's radar. When irregular trading activity is detected in a company's stock, the stock exchanges and the SEC scrutinize all transactions made during the suspicious period under review. Once the government's radar is on, it tries to investigate and match securities transactions back to company personnel to discover any insider trading.

### **III. Severe Penalties**

Anyone found liable in a civil case for trading on inside information may need to pay the government an amount equal to any profit made or any loss avoided and may also face a penalty of up to three times this amount. Persons found liable for tipping inside information, even if they did not trade themselves, may face a penalty of up to three times the amount of any profit gained or any loss avoided by everyone in the chain of tippees. Individuals can be barred from serving again as an executive or a director of a public company and can also face private lawsuits. These penalties are not the only consequence of an insider trading violation and investigation. Publicity and embarrassment also surround the investigation, even if it does not result in any formal charges, and damage is done to the company's business and image.

Individuals who are convicted of criminal insider trading face prison terms (the Sarbanes-Oxley Act increased the maximum length of sentences) and additional fines. In addition, violators are usually charged with mail and wire fraud and possibly with tax evasion and obstruction of justice. Corporations

face additional penalties for failure to set up compliance programs and make reasonable efforts to prevent violations under the theory of "controlling person" liability.

#### **IV. Insider Trading Applies to Stock Options and Company Stock in 401(k)**

If you exercise stock options when you know material non-public information, the exercise itself is not a violation, according to most experts. However, if you subsequently sell stock into the market in connection with the exercise of the options, which happens with a cashless exercise/same-day sale, the Rule 10b-5 insider trading prohibition is triggered as with any stock sale. Even after you leave the company, such as in any post-termination exercise period, the insider trading rules apply.

Buying or selling company stock in your 401(k) when you know important, confidential information about your company, such as an upcoming merger or better/worse financial results, is also insider trading. In February 2001 the SEC brought an insider trading case alleging an employee transferred 401(k) funds into his company's stock investment alternative after he learned about a soon-to-be-announced merger.

#### **V. Insider Trading Damages Goals of Employee Ownership**

Without employee education, insider trading can be the accidental consequence of employee ownership. Stock options and other equity grants turn employees into excited owners. They may now have access to confidential information, so they must be educated to know they cannot use it for their personal gain. In addition, employees naturally want to boast to friends and families about their companies' prospects. Doing so could result in an insider trading violation because they may provide information that someone may use as a stock tip. No matter how well intentioned the employee might be in bragging about the company or defending it (e.g., dispelling negative rumors through the use of net stock forums), this action is illegal.

Moreover, insider trading destroys a major rationale for stock options, which is a link between the financial interests of employees/executives and those of the shareholders. Employees and shareholders both benefit when the stock price rises. Because of their grants, employees will work harder and smarter to make this happen, supporters of options explain. However, this link with shareholder interests breaks down when the "insider" knows and uses information he/she learns on the job to buy or sell securities. Furthermore, as is alleged at Enron, executives may intentionally manipulate the earnings and then use this knowledge of their illegal activity to sell stock at inflated prices. The public shareholders (and other employees), not knowing this private information, may continue to hold their stock as it drops.

#### **VI. Employee Meetings, Seminars, and Videos**

Companies hold compliance meetings to discuss insider trading rules and their trading policies, including any window and blackout periods. A popular training tool is the Think Twice video series on preventing insider trading, which is available from Brumberg Publications. For more information on the videos, call 617-734-1979.

**For more details on insider trading law, see the insider trading FAQs on [myStockOptions.com](http://myStockOptions.com) and [TheCorporateCounsel.net](http://TheCorporateCounsel.net).**