



THE LAW | You overhear a CEO discuss a takeover his company will launch. You act on the tip and make a killing.

By Andrew Feinberg

Are you guilty of **INSIDER**

WHEN DOMESTIC DIVA Martha Stewart goes on trial in January to face a variety of charges stemming from her alleged insider trading of ImClone Systems stock, many Americans will be gleeful. Their delight in her fall from grace—*schadenfreude* with a vengeance and a doily—is nearly palpable. And their curiosity (just how would she decorate a prison cell anyway?) is intense.

But seeing her in the dock could make some investors edgy. They may worry about the legitimacy of the profits they've earned off stock tips they've received over the years and wonder, "Could the government have chosen me as a target instead of Martha Stewart?" When, exactly, do a few words from a colleague, a relative, a poker buddy or a broker become the stuff of insider trading?

Insider-trading laws are filled with gray areas. "My students love when I talk about insider trading because they find it glamorous and because some of the examples are so counterintuitive," says Theresa Gabaldon, a professor at George Washington University Law School. "If you steal information from your

employer, for instance, you're in trouble. But a cat burglar can trade on any information he steals." That's because, under securities laws, a burglar doesn't have any duty to the victims of his crime. (The break-in is another matter. And, of course, an aggressive prosecutor could *try* to bring insider-trading charges.)

On the other hand, if a friend tells you ever so casually that this might be a good week to sell shares of the company for which he works, you could face charges if you act on his advice. It would all depend on the context, on exactly what was said and on his position at the company.

Insider-trading laws came into being after the crash of 1929. Congress enacted the Securities Act of 1933

and the Securities Exchange Act of 1934 to curb common abuses of the era. The 1934 act specifically addressed insider trading, although "insiders" were defined narrowly as corporate officers, directors and owners of at least 10% of a company's stock. Later court cases and Securities and Exchange Commission regulations broadened the definition to include corporate "outsiders" and people who receive illicit tips.

But the line between legal and illegal trading is still murky. Suppose, while on a plane, you discover a top-secret memo that General Electric CEO Jeffrey Immelt left behind describing an imminent takeover bid for Amersham PLC. Can you trade on this information? Absolutely.

TRADING?

What if you overhear two GE executives discussing the deal? Again, trade to your heart's content. Granted, the SEC might call you to question your suspiciously prescient trades. But once it learns the details from you or the lawyer you may feel compelled to hire, you will be exonerated, just as Barry Switzer was.

Switzer led the University of Oklahoma football team to three national titles and then won Super Bowl XXX as the coach of the Dallas Cowboys. While sunbathing at a track meet in 1981, he overheard a CEO tell his wife that he'd just hired Morgan Stanley to advise him on the sale of a subsidiary, part of which traded publicly. Switzer called his broker and some friends, and all bought shares of the subsidiary. They enjoyed a nice payday.

Switzer was acquitted at his 1984 trial because the conversation he overheard was not conducted with "an improper purpose," according to the judge who tried the case. Had the CEO instead given an illicit tip to a friend, and had Switzer overheard *that*, the legal outcome might have been far different.

CRITICAL TRIGGERS

AS THESE EXAMPLES make clear, it is not simply the *use* of material, nonpublic information that gets you into hot water. You are guilty of insider trading if you are a corporate insider who trades on such information, or if you misappropriate—that is, trade on—information that rightly belongs to someone else, such as an issuer of securities. "Misappropriation" applies to an investment banker who trades in advance of a merger deal, for example, or to a printing-press worker who sells information about an article he sees ahead of its publication (as happened in a case involving *Business Week* some years ago).

Tip recipients—known as tippees—will often be found guilty, too.

There is another category of guilt that involves the so-called mosaic theory. If you put together disparate clues—say, the appearance at your company of officials from an acquisitive rival, or the arrival of six wingtip-wearing investment bankers from Goldman Sachs—and buy stock in your employer because it may soon receive a takeover bid, you will not be congratulated on your cleverness. The SEC may sue you.

As is often the case, specific facts determine the ultimate outcome. For example, what if your brother-in-law, a biotechnology researcher, tells you about a promising new molecule his company recently discovered. Can you trade? "The answer depends on the

context," says Christopher Bebel, a partner with Shepherd Smith & Bebel, in Houston. "For instance, is the information material? Would it change a reasonable investor's opinion of the stock? If the product is in a very early stage of discovery, there is probably no problem. But it also depends on how closely guarded this information is."

Or, suppose at a poker game your buddy, a merger lawyer, lets something slip about a deal. This is dangerous territory because you know he sometimes has access to material, nonpublic information. Your friend is probably guilty if you trade. But you might not be in legal jeopardy unless, according to the law, your relationship is such that you should have known that your friend expected you not to act on the information he disclosed to you. If your friend says "this is very hush-hush," you'd be wise not to trade.

In fact, the insider-trading laws were changed three years ago to make prosecutions easier. Under the new rules, it's

Guilty or not, lawyers advise against your talking to the SEC if it calls you about insider trading.

Walking a FINE LINE

ACCORDING to many defense lawyers I interviewed, I'm not a felon. But over my 37-year investing career, I've been involved in several cases that, in retrospect, might have raised insider-trading questions. Two decades ago, a friend, now deceased, who managed money told me to buy shares of Blastoff Inc. (the name has been changed to protect *everybody*). I had learned to trust his advice, so I asked no questions. I bought at \$3 a share. Two months later, he told me to sell, so I did, at \$6. Within six weeks, the stock took a death dive to a nickel.

Was this illegal insider trading? I can't imagine it wasn't. Did I know enough about it to be guilty? Ah, the empty-head defense to the rescue. No head could possibly have been emptier than mine, although for many months I worried about getting a call from the SEC.

Much more recently, I thought I had discovered that my bank was defrauding me. So, I wondered, if I researched the issue and learned that the fraud was widespread, could I short the stock (a bet on falling prices) before writing about it as a freelance journalist? Legally, yes, although that would certainly have raised ethics issues (I would have fully disclosed my position). But if I had been a full-time employee of, say, the *Wall Street Journal* when I discovered the fraud, and had traded on the information, my sale would be insider trading. That's because I would have been misappropriating information that belonged to my employer—not to me. —A.F.

GUIDELINES

How to **AVOID** traps

Follow these rules, and you'll diminish the likelihood of winding up in the same kind of jam that shredded Martha Stewart's reputation and led to her resignation as chairman and CEO of Martha Stewart Living Omnimedia.

If someone gives you a tip, ask enough questions to be sure you're not trading on inside information.

Don't give someone else inside information—even your spouse. If a tippee trades on that information, you're open to prosecution, even if you never make a penny.

Think twice before encouraging a family member to buy or sell stock in your company—even if you're just teaching your kid about investing. Events could unfold in a way that makes the transaction look suspicious, even if it is entirely innocent.

Keep up-to-date with your company's trading policies when you're buying or selling company stock.



● Stewart's trial begins in January.

now assumed that an insider has a "relationship of confidentiality" with close family members. If you show off knowledge of confidential information to your 18-year-old daughter, and she trades on it, you're both in trouble—if, that is, she had reason to believe it was truly inside information.

The legal concept in question here is "scienter," doing something with fraudulent intent. If you didn't know the information was tainted, you're okay. "The empty-head defense can work," says Bebel. "But willful blindness is not a defense." Translation: If you sell after learning that the CEO and his relatives were bailing out of a stock the day before a pivotal Food and Drug Administration meeting, your failure to see a connection might not be perceived as credible.

But consider an executive who gets sloshed at a bar and loudly divulges in-

side information. The next day he remembers nothing of what he said. But other bar patrons do, and many trade profitably on the tip. Well, this was an actual SEC case. The SEC sued the tippler—er, the tipper—but left the tippees alone.

BIG BROTHER WATCHES

DON'T ASSUME you can fool authorities by flying under the radar. The SEC periodically targets small fry precisely to discourage such thinking. Recently, the SEC brought a case against a man whose gains totaled all of \$500. The SEC and the exchanges have the power to detect virtually every move you make.

Several kinds of activities are sure to arouse the SEC's suspicion. "Buying on margin, buying options for the first time, buying stock for the first time or making a much larger trade than usual

are red flags," says Paul Berger, associate director of the SEC's division of enforcement. Acting too close to the date of a major announcement and "doing anything that is out of the ordinary for you as an investor are also warning signs," adds Nancy Grunberg, a former SEC enforcement official.

Guilty or not, lawyers advise against talking to SEC officials if they contact you about insider trading—instead, have your lawyer answer their questions. You may not have all the relevant information at your fingertips, and if the SEC catches you in a mistake, you could face charges of making a false statement. In addition, people have a tendency to tell stupid lies to government investigators. "You can turn a civil case into a criminal one by lying your butt off," says Ted Sonde, another former SEC official.

The case of Martha Stewart may be instructive. Stewart, who is accused of obstruction of justice and securities fraud in the criminal case set to begin in New York City in January, faces only civil charges of insider trading. The SEC alleges that Stewart traded on an "unlawful tip" from her broker that ImClone CEO Sam Waksal and his daughter were trying to sell all the ImClone shares they held at Merrill Lynch. Such information, the SEC states, was confidential under Merrill Lynch's policies. Stewart denies wrongdoing.

Lawyers say that Stewart's insider-trading case will come down to a question of scienter. Did she *know* she was doing something wrong when she sold her ImClone stock? If your broker told you to sell because some of his "smartest clients are selling," you could probably trade with impunity. But what if he told you a top executive with the company was selling? Or the CEO just prior to a key FDA decision? Such a case has never before been litigated. It's one of those gray areas. **K**

—Reporter: **JOAN GOLDWASSER**

The author, Andrew Feinberg, is a columnist for Kiplinger's Personal Finance.

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