

Insider Trading Question:

Carol is an investment banker. Bob, her fiance, who lives with her, overhears her talking about a proposed acquisition of a target company. He goes out and buys shares in the target company and makes a profit. Do you think Carol and/or Bob have or should have liability under s10(b) and Rule 10b-5?

First, let us notice that there is a question about the materiality of the information. It did lead Bob to buy the shares and he made a profit. We don't know if an announcement of the proposed acquisition produced the increase in price that led to the profit. If it did, the information looks to be material (information that would be important to the reasonable investor in making the investment decision: Texas Gulf Sulphur).

Bob buys shares in a prospective target of an acquisition. In order to think about this question we need to consider whether there is any basis for Bob to be precluded from trading in these shares.

Let's begin with Carol, because Bob's information came from her. For Carol, there is a question as to whether she is a tipper under Dirks when her actions lead to Bob learning information about the acquisition.

We don't know from the statement of facts how Carol knows about the proposed acquisition. There are a number of possibilities:

1. She learned about the proposed acquisition from her job (either working for the proposed acquirer or target)
2. She learned the information from someone else who may or may not have the information directly from the proposed acquirer or target

If 1, then Carol seems to be a temporary fiduciary under the Dirks footnote (emphasized in O'Hagan). If she is a temporary fiduciary she is under a duty only to disclose the information in a way that is consistent with her fiduciary duty. Dirks says she must not disclose the information in a way that she derives a personal benefit. Under Salzman a gift of information to a family member or friend can constitute a personal benefit under Dirks. Bob would be in the same category of a person to whom a gift of information could be treated as constituting a personal benefit to Carol.

The question tells us that Bob overhears the information. If Carol has a loud conversation about the deal expecting that Bob can overhear her this isn't very different from telling him the information. If she thinks he is out of the house that would be different. Allowing Bob to overhear the information could be tipping by Carol. Under Dirks Bob also has to understand that Carol is breaching her duties in letting him hear the information.

However, Carol may be relaxed about Bob overhearing her conversation because she expects Bob to maintain the confidentiality of any information he gets from her. If

Carol's communication is in the context of a relationship she expects to involve duties of confidentiality she should not be seen as breaching her fiduciary duty and therefore would not be a tipper under Dirks.

However, if the relationship between Carol and Bob is a fiduciary one then when Bob trades he is a misappropriator under O'Hagan. He obtained the information in the context of a fiduciary relationship and trading in the target company's shares is a breach of his duty so he is liable for insider trading under the misappropriation theory.

If Carol learned the information from someone else we do not have enough facts to know how to think about the issues. At some point the information will have come from someone with insider knowledge of the deal. If the links in the chain by which the information passes to Carol involve breaches of duty by insiders and an appreciation that there has been a breach of duty by the tippees then a tippee from a tippee can incur the disclose or abstain from trading obligation, and can be liable under §10(b) and Rule 10b-5 for trading or tipping. But as the chain grows it will be more complicated to establish the liability.