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To Our Clients

Trading on Inside Information under the New English Companies Bill

The Companies Bill introduced in the House of Commons on December 18, 1973 contains comprehensive provisions proscribing insider trading. In view of the current effort by the Securities and Exchange Commission to develop inside information guidelines under Rule 10b-5, 1934 Act Rel. No. 10316 (Aug. 1, 1973), and the codification proposal in ALI Fed. Securities Code §1303 (Tent. Draft No. 2, 1973), the English approach has special significance for American securities lawyers.

In general, the Companies Bill proscribes insider trading in the securities of the company with which the insider is connected if the insider has information which is not generally available but, if it were, would be likely materially to affect the price of those securities. This, of course, is the same general approach that has evolved under Rule 10b-5.

Who is an Insider. Insider is defined in the Companies Bill as (a) a director or employee of the issuer or a "related company" (subsidiary, parent or sister company), (b) a more than 5% equity owner of the issuer or a related company or (c) a person who has access to inside information either (i) directly or as a director or employee of another person through a business or professional relationship with the issuer or a related company or (ii) as a director or employee of a 5% equity owner of the issuer or a related company. Insider status terminates six months after the relationship which gives rise to that status terminates. Thus a trading transaction more than six months after termination of employment is not proscribed.

The definition of insider, except for the six month provision, is substantially the same as has been applied in the cases under Rule 10b-5 and as in §1303(b) of the ALI Code. Essentially it is premised on the fiduciary concept of special relationship with the issuer giving rise to a duty not to trade.

Quasi-Insiders. The Companies Bill includes within the insider category an insider of a company other than the issuer where the price sensitive information relates to a transaction between the issuer and the other company or a transaction involving one of the companies and the securities

of the other. Thus, for example, the Companies Bill proscribes trading in an issuer's securities by an insider of (a) a supplier or a customer of the issuer based on an increase or decrease in purchases or sales, (b) a takeover bidder about to bid for the issuer's securities or (c) an investor contemplating purchase or sale of the issuer's securities. Also included in the insider category are government or official employees who learn price sensitive information through their employment; a result reached by the SEC under Rule 10b-5 in Blyth & Co. [1967-69 Trans. Binder] CCH Fed. Sec. L. Rep. ¶77,647.

The Companies Bill is more specific and goes further than the ALI Code with respect to quasi insiders. See §1303 Comment (3). The Companies Bill seems to have provided the reasonable and convenient specificity Professor Loss finds so illusive in Comment (3) and leaves for ad hoc determination by the courts.

Tipping. The Companies Bill prohibits tipping by insiders and trading by tippees. A tippee is defined as a person who obtains information, directly or indirectly, from an insider and knows that the insider is such and at the time of obtaining the information was a relative or business associate of the insider or had an arrangement with the insider to obtain inside information for the purpose of trading. Thus, while indirect tippees (tippees of tippees) are included in the prohibition, the line is drawn before strangers who obtain inside information from an insider with whom there is no arrangement for communication of inside information for the purpose of trading.

While the approach of the Companies Bill in spelling out in detail the kind of relationship or arrangement with the insider that is necessary to constitute a person a tippee differs from the more general approach of ALI Code §1303(b)(4) which is all inclusive but authorizes ad hoc exclusion on determination that it would be inequitable to impose tippee status, as a practical matter the end result would appear to be substantially the same. There is much in favor of the certainty provided by the Companies Bill. The Companies Bill also differs from the ALI Code in that the Companies Bill proscribes tipping as well as tippee trading. See ALI Code §1303 Comment (7).

Tainted Companies. A company is tainted by its directors and employees. A company may not trade at a time when any director or employee of that company is an insider with price sensitive information. The ALI Code leaves this issue and the related "Chinese Wall" issue open. See §1303, Comment (6).

Chinese Walls. The Companies Bill, as does the City Takeover Panel rule, adopts the Chinese Wall approach to the problem of bankers and brokers being tainted by price sensitive information in the possession of their directors and employees. A company is not precluded from trading by reason of information in the possession of a director or employee if (a) the decision to trade is made by a person other than the tainted person, (b) formal arrangements for insulating the decision maker from any person in possession of the information were in effect and (c) no information or advice with respect to the trade was given to the decision maker by a person in possession of the information. The need for sanction of the Chinese Wall approach is highlighted by the recent decision in Slade v. Shearson, Hammill & Co., No. 72-4779 (S.D.N.Y. Jan. 2, 1974) in which the court said

> "Defendant Shearson is no doubt troubled by the realization that among the consequences of applying the rule enunciated in Texas Gulf Sulphur to transactions such as the one here at issue is that an investment banker/broker-dealer who possesses adverse information about a security in which it is dealing is disadvantaged vis-a-vis other broker-dealers who do not possess such information and hence are not disabled from soliciting purchasers. It must be remembered however, that Shearson voluntarily entered into a fiduciary relationship with Tidal Marine, as a consequence of which it received confidential information. Shearson also voluntarily entered into fiduciary relationships with its customers. It cannot recognize its duty to the former while ignoring its obligation to the latter. Having assumed fiduciary responsibilities, Shearson is required to incur whatever commercial disadvantage fulfillment of those obligations entails."

Price Sensitive Information - Materiality. The Companies Bill defines materiality in terms of "information which ... would be likely materially to affect the price". This fails within the middle range of the cases that have groped with this illusive concent (See, Gerstle v. Gamble -

Skogmo, Inc., 478 F.2d 1281 (2d Cir., 1973) which analyzes the recent cases and concludes that a probability rather than a possibility standard is proper saying that information is material "if its existence or non-existence is a matter to which a reasonable man would attach importance in determining his choice of action in the transaction in question.") and is substantially similar to ALI Code §1303(c)(1).

Disclosure - Generally Available. The Companies Bill does not provide specific guidance as to when information is generally available. The structure of the Companies Bill provisions is such that insider trading of listed securities can take place only after the price sensitive information is generally available; apparently disclosure to the other party to the trade will not satisfy the generally available requirement in the case of listed securities. Therefore, one is led to conclude that information with respect to listed securities is generally available, within the meaning of the Companies Bill, when it has been reflected in the market price. In the case of unlisted securities the Companies Bill contemplates disclosure to the parties as constituting general availability.

The question of when price sensitive information is generally available continues as one of the most troublesome insider trading issues. In S.E.C. v. Texas Gulf Sulphur Co., 401 F.2d 833, 854 n. 18 (2d Cir. 1968) the court said:

> "In any event, the permissible timing of insider transactions after disclosures of various sorts is one of the many areas of expertise of the SEC's rule-making power, which we hope will be utilized in the future to provide some predictability of certainty for the business community."

The SEC has not yet acted, although guidelines in this area may result from the comments in response to 1934 Act Rel. No. 10316 (Aug. 1, 1973) such as those of the ABA Committee on Federal Regulation of Securities which suggested:

> B. Previously undisclosed material information concerning an issuer will be deemed to have been publicly disseminated when such information has been released for transmittal to the financial community or communities (national, regional or local) comprising the principal trading market or markets for the securities of the issuer, through such means of communication as may

reasonably assure, in light of the extent of the market significance of the issuer's securities and of such information, that such information will thereby become public knowledge in the relevant financial community or communities.

C. Insiders may lawfully trade in the securities of an issuer as to which material information has been publicly disseminated (within the meaning of Subsection B above) after the earlier of (i) the end of the first complete calendar day during which any major stock exchange is open for trading or the NASD Automatic Quotation System is in operation, following receipt of such information by the relevant financial community or communities, or (ii) the end of the seventh complete calendar day following release of such information for transmittal to the relevant financial community or communities.

Market Information. The Companies Bill does not distinguish between market information and corporate information - if price sensitive, the prohibitions apply whatever the nature of the information.

Restricted Lists. The Companies Bill solves the problem of the broker who has nonpublic price sensitive information and receives an unsolicited order. There is a specific exception for a person who "enters into the transaction as agent for another person and has neither selected nor advised on the selection of the securities to which the transaction relates."

Causation. In Investors Management Co., [1970-71 Trans. Binder] CCH Fed. Sec. Rep. ¶78,163 the SEC held that there would be a Rule 10b-5 violation only if the information was a factor in a tippee's decision to trade; if the trading decision was based on something else (and such was proved as a fact) there was no violation. The Companies Bill adopts a different approach; it focuses on the purpose of the trade. If the purpose of the trade was not, or was not primarily, the making of a profit or the avoiding of a loss by the use of price sensitive information, an insider or tippee is not prohibited from trading. If nothing else, it may be easier to establish the fact of the Companies Bill exception than to establish that the information was not a factor.

Damages. The Companies Bill avoids the problems of rescission by denying that remedy and limiting civil liability to compensation to "any other party to the transaction who was not in possession of [the] information for any loss sustained by that party by reason of any difference between the price at which the securities were dealt in and their likely price if [the] information had been generally available." It is apparent that not having had the experience we have had in coping with Rule 10b-5 damage issues, the English have avoided only some of the problems dealt with in the ALI Code and Schapiro v. Merrill Lynch Pierce Fenner & Smith Inc. 353 F. Supp. 264 (S.D.N.Y., 1972) which held that in exchange transactions where matching of buyer and seller is not possible Rule 10b-5 insider trading liability runs to all buyers even though the tainted seller sold only 100 shares.

Equality of Information. The Companies Bill does not mandate absolute equality of information in all trading situations. The large investor may still buy or sell in material amounts without disclosing his intent as to future purchases or sales - the "creeping" takeover bid having been dealt with separately by lowering the reporting threshold from 10% to 5% and the notification period from 14 to 3 days following the purchase of the acquisition of the threshold amount. The person with price sensitive information who does not come within the broad sweep of the insider and tippee definitions is also free to trade. The analyst who obtains price sensitive information from outside sources may still act upon it. On balance, the Companies Bill appears to have resolved successfully the public expectation that it will not be taken advantage of and the practical necessities of everyday trading in the securities markets. Unless we are to have complete separation of the traditional brokerage, investment management, investment banking and commercial banking functions, it is essential that we sanction Chinese Walls and unrestricted execution of unsolicited orders by brokers. The proper functioning of the securities markets is also aided by certainty as to who is within the insider and tippee categories. In all these respects the Companies Bill has met the need.

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