Negligent Insider Trading: A viable theory of civil liability?

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A flurry of civil suits by the SEC and private parties has followed on the heels of the collapse of the subprime mortgage market. Many of these actions raise theories of liability that are still developing in the area of white collar crime and securities fraud. As the SEC and private parties seek to explore new theories under which to bring suit, this article briefly addresses one as-yet unexplored avenue that many academic authorities have alluded to as possible under Section 17 of the Securities Act of 1933: that of “negligent insider trading.” While such a theory has yet to be charged, the recent SEC action against Angelo Mozilo, former CEO of Countrywide Financial Corp. incorporates language that suggests such an approach and presents a timely opportunity to assess the viability of such a charge. I ask whether this theory should be permitted in light of conflicting case law and statutory authority, and conclude that indeed it should not.

In the June of 2009, the SEC brought charges of insider trading against Angelo Mozilo and other officers of Countrywide.\(^1\) The complaint alleges violations of both Section 17 of the Securities Act of 1933 and Section 10 of the Securities Exchange Act of 1934 (SEC Rule 10b-5).\(^2\) Insider trading can violate both these sections.\(^3\) In fact, there is nothing unusual in charging violations of both sections, and this may just be the sort of piling on of charges


\(^2\) *Id.*

one expects from prosecutors. But what makes the Mozilo complaint interesting is that it
appears to incorporate, at times, the language of negligence, and not just scienter (see
below).4 This raises the question—alluded to briefly in various academic sources with little
exposition—of whether a charge of “negligent insider trading” is possible under Section 17,
which has different intent requirements than does Rule 10b-5.

Section 17(a) states in part:

“It shall be unlawful . . . (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.”5

But unlike Section 17(a)(1) and Rule 10b-5, both of which require scienter,6 Section
17(a)(2) and (a)(3) generally require only a showing of negligence.7 In Aaron v. SEC, 446
U.S. 680 (1980), the Supreme Court granted certiorari specifically to address whether
scienter is a requirement for a violation of certain federal anti-fraud provisions.8 The Court
held that while scienter is a requirement for violations of Rule 10b-5 and Section 17(a)(1),
the language of Section 17(a)(2) and (a)(3) is “devoid of any suggestion whatsoever of a

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4 SEC Complaint at ¶ 33.
6 See Aaron v. SEC, 446 U.S. 680, 695-96 (1980). Regarding the sale of securities by an
insider, § 17(a)(1) and Rule 10b-5 are thus essentially redundant. S.E.C. v. Banner Fund Int’, 211
F.3d 602, 609-10 (D.C. Cir. 2000) (“Section 17(a) is in substance almost identical to § 10(b) of the
1934 Act and to Rule 10b-5”).
7 Aaron v. S.E.C, 446 U.S. 680, 697 (1980); SEC v. Dain Rauscher, Inc., 254 F.3d 852, 856 (9th
Cir. 2001) (finding an investment banker may have violated Section 17(a) through negligent
preparation of an offering statement for a new security); Andresen v. Hunt, 1991 WL 268716 at *2
(9th Cir. 1991) (citing Aaron for the proposition that “subsections 17(a)(2) and (3) do not require
scienter”); SEC v. Soroosh, 1997 WL 487434 (N.D. Cal. 1997), aff’d, 166 F.3d 343 (9th Cir. 1998)
(same); S.E.C. v. Truong, 98 F.Supp.2d 1086, 1096 (N.D. Cal. 2000) (“the language of subsections
(2) and (3) cannot support a scienter requirement”).
8 446 U.S. at 686.
scienter requirement” and that (a)(3) in particular “quite plainly focuses upon the effect of particular conduct on members of the investing public, rather than upon the culpability of the person responsible.”

Thus, a charge of “negligent insider trading” is at least theoretically possible. But while negligence has been used in charging violations of Section 17, and insider trading can violate subsections (a)(2) and (a)(3), research did not uncover any record of an express charge or adjudicated case of “negligent insider trading.” Only one court came close to examining the question. In *SEC v. Soroosh*, 1997 WL 487434 (N.D. Cal. 1997), the court observed that subsections (a)(2) and (a)(3) require only a showing of negligence and subsequently asked “whether [defendant] knew or should have known of [his information’s] materiality.” The court went on to find that the defendant had scienter, however, and seemingly set aside the question of negligence.

Some defendants have responded to insider trading charges brought by the SEC pursuant to Section 17(a)(2) and (a)(3) with anticipatory denials of negligence and/or assertions that no cause of action exists for negligent insider trading. However, the SEC’s motions and pleadings in these cases have asserted recklessness, not mere negligence.

In the SEC complaint against Angelo Mozilo the SEC has not expressly alleged negligence in its Section 17(a) causes of action. But if “negligent insider trading” is indeed

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9 Id. at 697.
10 1997 WL 487434 at *6 (emphasis added).
11 Id. at *7.
12 See Brief of Defendant at 21, *SEC v. Berlacher*, 2009 WL 1063935 (E.D. Pa. 2009) (arguing that the SEC’s ‘negligent insider trading’ claim fails as a matter of law because insider trading requires scienter, though no such express charge appeared in the pleadings); see also *SEC v. Snyder*, 2005 WL 2578326 (applying a recklessness standard and failing to reference negligence alluded to in defendant’s motions to dismiss).
13 The Mozilo complaint does not allege “insider trading” in violation of Section 17, but merely a generic violation of the statute. While the complaint alleges that Mozilo “with scienter, employed
a real violation, the SEC might well argue that they have adequately pleaded it since the complaint appears to incorporate the language of negligence: “The credit losses experienced by Countrywide in 2007 not only were foreseeable by the proposed defendants, they were in fact foreseen.” Such language may set the stage for the SEC to argue that Mozilo either knew or should have known that the company asserted financial position was not accurate and that selling his shares on the basis of those assertions would thus act as a fraud upon the buyer in violation of Section 17(a)(3). Similarly the SEC might argue that Mozilo “obtained money or property” from the purchasers through his negligent failure to correct financial misstatements or through negligent omissions in such statements, in violation of Section 17(a)(2).

However, despite the apparent theoretical possibility of a charge of “negligent insider trading,” as I argue below, such a theory conflicts with Rule 10b-5, which supersedes Section 17 when applied to insider trading as the more recent and specific of the two statutes, and which requires scienter.

14 SEC Complaint at ¶ 33 (emphasis in original).
16 It seems highly unlikely that the SEC would pursue a “negligent insider trading” cause of action, based on its history of alleging at least recklessness, but the complaint probably alleges sufficient facts should they seek to do so. The pleading in S.E.C. v. Lyon, 529 F. Supp. 2d 444 (S.D.N.Y. 2008), for example, were no more specific in their Section 17(a) cause of action than are the pleadings in the Countrywide complaint.
A. Resolving the conflict between Section 17 and Rule 10b-5 in insider trading actions

It is a well established that “[w]hen two statutes conflict the general rule is that the statute last in time prevails as the most recent expression of the legislature's will.”\textsuperscript{17} Moreover, when such a conflict arises “a specific statute closely applicable to the substance of the controversy at hand controls over a more generalized provision.”\textsuperscript{18}

We first note that a theory of negligent insider trading under Section 17 conflicts with Rule 10b-5. This is because the language of 10b-5 itself makes it clear that law of insider trading is governed exclusively the Rule and the judicial opinions that have interpreted it. Specifically, Rule 10b-5 reads in part as follows: “This provision defines when a purchase or sale constitutes trading “on the basis of” material nonpublic information in insider trading cases brought under Section 10(b) of the Act and Rule 10b-5 thereunder. The law of insider trading is otherwise defined by judicial opinions construing Rule 10b-5.”\textsuperscript{19} Moreover, a violation of Rule 10b-5 requires a showing of scienter.\textsuperscript{20} This requirement has been derived without controversy from language in Section 10(b) of the Securities Exchange Act of 1934 which targets the use of “any manipulative or deceptive device or contrivance.” According to the Supreme , “the use [in Section 10(b)] of the words ‘manipulative,’ ‘device,’ and ‘contrivance’ . . . make unmistakable a congressional intent to proscribe a type of conduct

\textsuperscript{17} Boudette v. Barnette, 923 F.2d 754, 757 (9th Cir.1991) (finding that that a federal rule of civil procedure prevailed over an earlier passed but conflicting section of the United States Code); International Union v. Auto Glass Employees Fed. Credit Union, 72 F.3d 1243, 1247 (6th Cir.1996) (the more recent statute controls because it is the “settled principle of statutory construction that when Congress drafts a statute, courts presume that it does so with full knowledge of the existing law”).

\textsuperscript{18} Farmer v. Employment Sec. Comm'n of N.C., 4 F.3d 1274, 1284 (4th Cir.1993) (citing HCSC-Laundry v. United States, 450 U.S. 1, 6 (1981)).

\textsuperscript{19} 17 C.F.R. § 240.10b5 (emphasis added).

\textsuperscript{20} Ernst & Ernst v. Hochfelder, 425 U.S. 185, 198 (1976).
Thus, a charge of negligent insider trading under Section 17(a)(2) or (a)(3) conflicts with the law of insider trading as defined by Rule 10b-5 and the judicial opinions construing it.

I now turn to the question of which statute controls. Here, the answer is quite simple. First, section 17 of the Securities Act of 1933 predates Section 10(b) of the Securities Act of 1934 and any subsequent amendment to or clarification thereof, such as Rule 10b-5. Second, Section 10(b) is specific to the offense of insider trading, as it states, “[r]ules promulgated under [this section] . . . prohibit insider trading.” By contrast, Section 17 is, on its face, a generic anti-fraud provision. Thus, Section 10 and Rule 10b-5 speak directly to the offense of insider trading, while Section 17 does not. Section 10 and Rule 10b-5 are thus both more recent and more specific than Section 17, and are therefore controlling in insider trading actions.

B. Congressional intent

To permit a charge of negligent insider trading under Section 17 would run counter to congressional intent in the creation and development of Rule 10b-5. Had Congress intended the generic provisions of Section 17 to serve as a prohibition of insider trading, it would not have enacted and developed Section 10 and Rule 10b-5 specifically for that purpose, with the result that “[t]he legal principles governing the majority of insider trading cases are well-established and widely-known.” To allow the SEC (or any other entity) to fashion a new

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21 Id.
22 15 U.S.C. § 78j. See also 17 C.F.R. § 240.10b5-1 (“This provision defines when a purchase or sale constitutes trading ‘on the basis of’ material nonpublic information in insider trading cases”).
theory of the offense unsupported by any prior caselaw directly conflicts with Rule 10b-5’s mandate that “[t]he law of insider trading is otherwise defined by judicial opinions construing Rule 10b-5.”

Finally, it bears emphasizing that Congress has on several occasions rejected proposals to pass an explicit statutory definition of insider trading, preferring instead to rely on the line of cases that construe Section 10. The SEC itself has supported this approach. In a letter to Congress in 1983, the SEC wrote, “Existing law provides a sound legal framework for judicial analysis and review of the new and unforeseeable trading devices and strategies [used in insider trading]. Decades of legal thinking have contributed to the development of existing antifraud law under Rule 10b-5.” Thus both the SEC and Congress consider Section 10, Rule 10b-5, and the judicial opinions construing those provisions, to be the basis of causes of action for insider trading. To allow the SEC to invoke a cause of action for negligent insider trading pursuant to Section 17 would therefore be to undermine “decades of legal thinking.”

C. Conclusion

With so many casualties of the subprime mortgage collapse (and indeed of the recession in general) there is no shortage of plaintiffs and defendants in securities actions at

24 17 C.F.R. § 240.10b5-1.
25 See Donald C. Langevoort, Insider Trading Regulation, Enforcement and Prevention, § 2:13 (3rd Ed. 2009) (noting that Congress has preferred the flexibility afforded by allowing the courts to develop the prohibition of so complex an economic offense).
27 Id.
the moment. New theories of liability will no doubt be explored. But while a charge of “negligent insider trading” has long been thought theoretically viable, one must conclude that it is not tenable given the nature and scope of Rule 10b-5.