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Regulatory: Insider trading and confidentiality agreements

Prevent employees from going astray by alerting them to their responsibilities

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Companies often execute confidentiality agreements or nondisclosure agreements for a variety of purposes and fail to consider the implications that such agreements have on insider trading liability. The breach of a confidentiality agreement may be an essential element of the government's insider trading case. Duties under confidentiality agreements should be centrally tracked and relevant employees should be made aware of such provisions to prevent employees from going astray, either by trading based on material nonpublic (inside) information or disclosing such inside information to another person that trades in securities on that basis in violation of such agreement.

Insider trading liability is premised upon two separate and independent theories:

1. Under classical theory, insider trading occurs when a company insider trades in the securities of his or her company on the basis of material nonpublic (inside) information. This theory applies not only to officers, directors and other permanent insiders of a company, but also to attorneys, accountants, consultants and others who temporarily become fiduciaries of a company.
2. Under misappropriation theory, insider trading occurs when someone misappropriates inside information for securities trading purposes, in breach of a duty owed to the source of the information. Breach of a confidentiality agreement may serve as the requisite breach of duty in certain circumstances. If the confidentiality agreement is not intended to restrict securities trading, the agreement should expressly state that, as the Securities and Exchange Commission (SEC) asserts that a

confidentiality agreement alone can satisfy the duty requirement of insider trading.

Under both theories, an insider (tipper) who discloses inside information to another person (tippee) in breach of either of those duties may extend insider trading liability to the tippee and further remote tippees, even if the tipper does not trade. Liability will not attach to tippees unless, among other things, the tipper breached a duty of trust or confidence owed to the source of the inside information by providing that information to a tippee, and the tippee knew or should have known of the breach. The tippee must subjectively believe that the information he or she received was obtained in breach of a fiduciary duty.

When an employee of a company breaches its company's code of conduct and trades based upon, or discloses inside information to another person about the company, its vendors or customers in violation of the company's code, such action may serve as the necessary breach of trust in an insider trading case, implicating the employee and any tippee that was or should have been on notice of the breach that traded securities based on such inside information. Codes of conduct and employment agreements usually implicitly or explicitly require employees to abide by the confidentiality agreements to which the company is bound.

In July 2011, a vice president of Flextronics that had provided inside information on Flextronics' customers, including Apple, to third parties as a consultant that was part of an expert network, pleaded guilty to insider trading. The government alleged that the corporate officer had violated Flextronics' code of business conduct and ethics and Flextronics' nondisclosure agreement with Apple.

SEC Rule 10b5-2 provides a non-exclusive list of circumstances under which a duty of trust or confidence exists sufficient to establish liability under the misappropriation theory, including where a person receiving the information agreed to maintain the information in confidence.

A renewed government focus on insider trading cases with a goal of capturing a large number of wrongdoers heightens the importance of adopting policies and procedures in the insider trading area. Public companies, investment management firms and broker-dealers have long been subject to statutes and regulations requiring them to maintain and enforce adequate policies and procedures to detect and prevent insider trading. Tracking personnel and alerting them to their responsibilities under confidentiality agreements should be a part of such policies and procedures. In light of the current regulatory environment, even non-financial and nonpublic companies would be well served to educate employees on insider trading developments.

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