CADY, ROBERTS & CO., 40 SAEC 907 (1961) — CASE ANALYSIS

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ABSTRACT

This case analysis is based on the first case that has shaped today's insider-trading law. Through this, the SEC had become the torch-bearer for the world that, insider trading meant much beyond manipulation of markets. Beyond this case, jurisprudence evolved that has had a great impact on the insider trading law as we see it today. This article deals with the *Cady, Roberts & Co.* Case in detail and thereafter deals with how the insider trading jurisprudence evolved in the United States of America along the 'possession' v. 'use' debate. Lastly, it deals with how, if this case was to happen today, Indian law would deal with the same set of facts.

1. FACTS

There are four people at play in the present case, which include Curtiss-Wright Corporation and one of its directors J. Cheever Cowdin referred as 'Cowdin' in the judgment, the broker firm of Cady, Roberts & Co. referred as 'Registrant' in the judgment and Robert M. Gintel, a partner of the firm referred as 'Gintel' in the judgment.

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The incident that led to the case, happened on the 25th of November 1959. Within a few minutes it came to be regarded as one of the first cases of insider trading in the history of the United States of America. It so happened that, Mr. Cowdin was a registered representative of Cady, Roberts & Co. from July 1956 till March 1960, having been elected to the Board of Directors since 1929. On this particular day, a meeting was being held to discuss *inter alia*, a declaration of quarterly dividend which, for the last three quarters, stood at $0.625 per share. It was decided in the Board Meeting that, in this quarter, the dividends would be announced at a reduced rate of $0.375 per share. The information regarding such reduction in payment of dividends was authorised to be sent to the New York Stock Exchange via telegram at 11:00 a.m. However, the transmission could not be done until 12:29 p.m. because of a typing problem. even when the message was delivered to Western Union at 11:12 a.m. The company had a customary obligation to display on the Dow Jones Ticker System, any dividend-related information. This was also delayed due to some technical error, and Wall Street Journal received the news only at 11:45 a.m., and the ticker displayed the information at 11:48 a.m.

While this had all happened, back in time when the dividend decision had just been taken, a recess of the meeting had been scheduled. It was then that Mr. Cowdin called the office of Cady, Roberts & Co. and left a message for Mr. Gintel that the dividend declaration had been reduced to $0.375 per share. Gintel, on receiving the information asked the New York Stock Exchange to execute two orders of selling 2,000 shares in Curtis-Wright and for selling short 5,000 shares for ten and eleven accounts respectively. These instructions were duly executed by the Exchange at 11:15 a.m. and 11:18 a.m., respectively. He then proceeded to sell 2,000 more shares for a mutual fund having a large position in the stock. An investment manager of this fund had expressed concerns to Mr. Gintel regarding the lowering of the dividend and had gone to the Curtis-Wright office at 11:00 a.m., to urge Curtiss-Wright not to lower the dividends.

The Curtiss-Wright dividend announcement appeared on the tickers at 11:48 a.m. and the Exchange had to stop trading operations on the stock due to the large number of sell orders. The trading resumed at 1:59 p.m.

2. PROCEDURAL HISTORY

After the admission of the case before the Securities and Exchange Commission, pursuant to §5(b) of the Administrative Procedure Act and Rule 8 of the Rules of Practice of the Securities and Exchange Commission, an offer of settlement was made by Cady, Roberts & Co. This particular offer of settlement included the proposition that the case could be adjudged on the facts stated by the respondent-authorities if Mr. Gintel's maximum punishment would be his suspension for 20 days from the New York Stock Exchange.

§ 5(b) of the Administrative Procedure Act allows the concerned parties to submit arguments, adjustments, and most importantly offers of settlement in every adjudication proceeding. The erstwhile Rule 8 of the

Rules of Practice of the Securities and Exchange Commission facilitated these offers of settlements, but has been replaced by the current §201.54 and § 201.240 of the Rules of Practice. The former stated that an agreement on a settlement may be done before the case is finally disposed and if in case it is agreed upon before the filing of the application before the Securities and Exchange Commission, then the application has to be filed with the offer of settlement. The latter rule is an elaborate procedural rule on how settlements are done before the Securities and Exchange Commission, who will sign the settlement and how it will be filed. It also mentions that the final acceptance of the offer of settlement will only occur upon an order of the Commission.

3. ISSUES AND HOLDINGS

1. Whether information regarding dividend was non-public price sensitive information?
2. Did Cady, Roberts & Co. have a duty not to trade based on that information or disclose the information?

The Court held that, such information regarding dividend was price-sensitive information and that Cady, Roberts & Co. had a duty not to trade based on that information or disclose that information.

4. RATIO DECIDENDI

The law that was relied upon for this case was, § 17(a) of the Securities Act of 1933, §10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated under the authority of the aforesaid § 10(b). This

§ 10(b) states that, it is "unlawful for any person to use, in connection with the purchase or sale of a security, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for protection of investors." These sections have their application to "any person" who are traditional 'insiders' – ones who have price-sensitive information based on their position that is not ordinarily available to persons they deal with. In this scenario, Cady, Roberts & Co. itself was held liable since the actions of Mr. Gintel was carried out during the course of his employment which was attributable to the firm itself. The section's use of the term, "any person", ordinarily includes officers, directors, and controlling stockholders but the list was not exhaustive and included persons who had the same obligations in particular facts and circumstances of a case. Persons who buy stock from an insider have the same protection afforded to them as the persons who sell the stock to them – the defrauded buyer and defrauded seller are thus kept on an equal footing.

The information regarding the decrease in the dividend for the quarter was such information to have an adverse impact on the company stock by affecting investment judgment. This information has a direct impact on the securities market, so much so that, it actually made the exchange stop trading the stock for a period of time.

Even though Mr. Gintel had a fiduciary duty towards the accounts of his clients, it could not justify a violation of the law to keep the accounts in a steady state. There was no manipulation of markets, but acting on such undisclosed information was an act, not valid in the eyes of law. However, the US Securities and Exchange Commission noted that, there was no evidence of a preconceived plan for Mr. Cowdin to inform Mr. Gintel of any decrease in dividends. Both the men acted in good faith – Mr. Cowdin presumed the information had already become public and was unaware of the transmission failure, while Mr. Gintel had acted at the spur of the moment, to protect his customers' interest without reviewing the information. Hence, he was put on a 20 day suspension, thus accepting the offer of settlement, as he had already been fined $3,000 by the New York Stock Exchange.

5. EVALUATION & SYNTHESIS

Pertinent to note that law has not changed and Rule 10b-5 is still in full force to prevent insider trading inside the United States. Rule 10b-5 is called the 'Employment of Manipulative and Deceptive Practices' section, and prohibits fraudulent activities, giving statements that are false, omitting relevant information, and deceit in general in the context of trading of securities. Any use of confidential information or any arrangement that might manipulate price of securities, would be dealt with under this rule.

There are certain general rules that have evolved over time since the *Cady, Roberts & Co.* case and now, there can be said to be three ingredients to constitute a violation of Rule 10b-5:

1. Scienter
2. Materiality of information

3. Use of information

The first condition of scienter requires that, the one alleged of wrongdoing has done it with the intention to do the alleged wrong. As in the cases requiring proof of *mens rea*, it can be inferred from certain facts and circumstances like the previous trading history of the wrongdoer[1] and, the particular circumstances that led to the transaction. Certain points were let-down, which included the following:

- The burden of proof of scienter lies on the party asserting such motive
- Transaction patterns of the wrongdoer
- Dramatic deviation of transaction pattern
  - Magnitude or value of the insider trading
  - Time of the transactions
  - Deviation from ordinary practice

For the second requirement of materiality, it has been laid down that all information cannot be termed as actionable. Only information that is material for price-variation is actionable.[2] Information regarding a company's upcoming projects which have not been made public, for example, information which is of such material nature.

For the third requirement, it is a stark contrast of Rule 14e-3 which emphasises on possession. Rule 14e-3 prohibits any trading in securities, when in possession of material non-public information regarding a tender

[1] *In Re*, Silicon Graphics, Inc., Securities Litigation, 970 F. Supp. 746 (1999).
[2] Securities Exchange Comm'n v. Texas Gulf Sulphur Co., 401 F.2d 833 (1966).

offer or otherwise. The words of focus here are, “in possession”. Rule 10b-5 jurisprudence rather emphasises on ‘use’ of non-public information, and not mere possession[3]. But possession, even though cannot fix liability, is enough to hit the Rule’s trigger of abstaining or disclose-obligation. This obligation has been clarified with the adoption of Rule 10b-5(1) by the Securities and Exchange Commission in August of 2000. The adoption of this rule was necessary to bring clarity to Rule 10b-5. Rule 10b-5(1) states, there is a presumption of ’use' if one is in the possession of information. This is, however, a rebuttable presumption and can be disproved by showing that such information was not used in making the trading decision, vide Rule 10b-5(1)(c)(1). This rule 10b-5(1)(c)(1) allows such presumption not to have effect when there was any action taken to sell the securities before becoming aware of the information or in pursuance of a contract, instruction or plan that was made before the information came into the knowledge of the person. The aforementioned presumption has certain exceptions as provided in Rule 10b-5(2), which are the following:

- The obtainee is a spouse, parent, child, or sibling of the discloser;
- The obtainee is, in habitual discourse, under a position to obtain information and can be said to maintain the information in confidence;
- Or that, the obtainee has agreed to maintain such information in confidence.

[3] U.S. v. Smith, 155 F.3d 1051 (1820); SEC v. Adler, 137 F.3d 1325 (1998).

6. FURTHER JUDICIAL CASES

Judicial pronouncements citing *Cady, Roberts & Co.* are many, since it was at the frontier of an era of insider trading cases from the Securities and Exchange Commission. In the case of *Speed v. Transamerica Corp.*,[4] *Cady, Roberts & Co.* was referred, while discussing the duty of disclosure of material non-public information which requires:

- Information that was meant only for the corporate purpose is accessed by a person, by virtue of his relationship with the insider.
- The inherent unfairness of such disclosure as against those trading without the information that was disclosed.

It further went on to state that a relationship of trust and confidence was in existence between the shareholders and the insiders that gave rise to the liability to disclose any non-public price-sensitive information that they might have. Uninformed minority stockholders are at a great disadvantage without access to information within the doors of the company.

In the case of *Chiarella v. U.S.*,[5] the Court again elaborated on the 'possession' v. 'use' jurisprudence which stated that, mere possession of material non-public information does not create a duty to disclose the information. That duty only arises when that information is sought to be used in making a trading judgment. The case discussed the contrast with Rule 14e-3, which makes even possession of such information actionable

[4] Speed v. Transamerica Corp., 99 F.Supp. 808, 829 (1951).
[5] Chiarella v. U.S., 445 U.S. 227, 228 (1980).

in the sense that it creates a duty to abstain from trading based on that information. Rule 14e-3 prohibits trading in company securities when information regarding the tender offer and commencement of bid on that tender.

The jurisprudential foundations of such insider trading cases are based on the property right to information.[6] There was a regulatory paradigm shift after the aforementioned *Chiarella* case.[7] Insider trading, thus, became illegal because it was unfair.

7. INDIAN LAW

The insider trading regulations in India are governed by the SEBI (Prohibition of Insider Trading) Regulations, 2015. Regulation 2(g) specifies who is an 'insider' and includes 'connected person' as defined in Regulation 2(d) and any person in possession of unpublished price sensitive information. Even in this case, *Cady, Roberts & Co.* would have come under the definition of an insider vide connected person under Regulation 2(d) they have access to unpublished information which they are reasonably expected to allow such access. This is by virtue of the special position they enjoyed with Mr. Cowdin where they were expected to have access to have such information but also had the duty not to act upon it until the information was made publicly available. The law of USA uses the term "any person", whereas the Indian law has specific

[6] Jonathan R. Macey, *Securities Trading: A Contractual Perspective*, 50 CASE W. RES. L. REV. 269, 273-74 (1999), *available at* https://scholarlycommons.law.case.edu/caselrev/vol50/iss2/10.
[7] *Id.* at 284-87.

definitions for who is an insider and connected person and these are the only persons on whom such regulations can be made applicable. Nonetheless, these definitions are extremely wide, and have within their ambit, all possible persons who can get access to and use such unpublished price sensitive information to their unfair advantage. The prohibition in Indian law is for two different actions – communication and/or procurement vide Regulation 3 and; trading with such information vide Regulation 4.

Unpublished price sensitive information as defined in Regulation 2(n) is much clearer in this aspect in comparison to Securities and Exchange Commission Rule 10b-5. Regulation 2(n) is a negative clause and includes every information that is not generally available[8], and might materially affect the price of securities. It further includes an illustrative list of such information which explicitly includes information relating to dividends. Regulation 2(1)(e) defines what is generally available information, and that is such information as is available to the public on a 'non-discriminatory' basis, i.e., anyone can freely access such information irrespective of their connection with the company. In simple terms, generally available information is such information that is available to any stranger as much as available to the top executives of the company. This 'non-discriminatory access' that is spoken about here, is inevitably, access without breaching any law. Thus, even though the general public can get hold of any information that is price sensitive through the use of means prohibited by cyber law, it would not amount to generally available

[8] Hindustan Lever Ltd. v. Securities Exchange Board of India [1998] 18 S.C.L. 311 (S.A.T.).

information. As such, *Cady, Roberts & Co.* would have been a case that would have directly violated the Regulations of S.E.B.I. if such a similar situation was to happen in India in the present day. The U.S. Securities and Exchange Commission Regulation 10b-5 is more ambiguous albeit open to broader interpretation with the use of the words ‘artifice to defraud’ and ‘fraud or deceit upon any person’. It is thus stated that the invoking of the Regulations has the ‘scienter’ requirement whereas statutorily, the regulations in India are lucid and strict.[9] In India, there is no requirement for *mens rea*, and the decision can rest on a preponderance of probabilities.[10] This enables a penal provision to operate without the strict requirements that such a provision usually entails to satisfy its requirements. The recipient of such information can therefore be held liable for fraud in case there is an “inducement to bring about an inequitable result”.[11]

Indian law is somewhat similar to US law, through the case of *Chiarella v. U.S.*,[12] and *Rakesh Agrawal v. S.E.B.I.*,[13] which said that the breach of fiduciary duty was the basis of affixing liability for insider trading. Both cases stated that it has to be read into the Regulations that, there should be the existence of a special relationship which would form the basis of liability. Thus, even though the words, “any person”, has been used in the text of US law, it cannot actually, in practice, be applicable on

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[9] Rakesh Agrawal v. Securities Exchange Board of India [2004] 49 S.C.L. 351 (S.A.T.).
[10] Securities Exchange Board of India v. Kanaiyalal Patel, 2017 S.C.C. OnLine S.C. 1148.
[11] *Id.*
[12] *supra* note 5.
[13] *supra* note 9.

any person. Apart from this, the earlier 'possession vs. use' debate is a significant point of difference between Indian law and US law. As stated earlier by citing *Chiarella*,[14] in the USA, mere possession cannot sustain an indictment under insider trading. Indian law, however uses the words "No person shall…while in possession of unpublished price sensitive information" in Regulation 4 and thus, makes trading in securities prohibited even with a mere possession of such information.

However, as in the *Rakesh Agrawal* case,[15] there is a presumption that the person dealing in securities acts for a personal benefit in such cases, which is a rebuttable presumption and can be disproved by appropriate evidence showing facts to the contrary. The decision to deal in securities, if independent of the possession of the unpublished price sensitive information, should be so proved. It will be sufficient if the unpublished price sensitive information was not used and was unconnected in the decision to deal with the securities for avoiding liability.[16] The words "on the basis of" used in the statute signify that the basis of the decision to deal in the securities should be the unpublished price sensitive information, i.e. the unpublished price sensitive information should be the motivating factor and circumstance of the

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[14] *supra* note 5.
[15] *supra* note 9.
[16] Chandrakala v. Securities Exchange Board of India, Securities Appellate Tribunal, Jan. 31, 2012, *available at* http://www.sebi.gov.in/cms/sebi_data/attachdocs/1327988739076.pdf (last visited July 3, 2017).

trading. If it is not so, and is proved to be otherwise, the onus stands discharged and the liability under the statute will not be attracted.[17]

In conclusion, *Cady, Roberts & Co.* started the wheels of punishment for insider trading, which had a ripple effect in all common law countries in the world. Further developments of law were suited to domestic needs in these countries, as and when that need arose. As we can see, the US law has been interpreted thoroughly through the various decisions as elaborated above, beginning with *Cady, Roberts & Co.*, but Indian law is a recent creation and therefore, it is a much more precise and elaborate piece of secondary legislation. The Indian law and the US law are almost at parity with each other now, in the particular aspects dealt with in this article, except for a few differences as pointed out above.

[17] Rajiv Gandhi v. Securities Exchange Board of India [2008] 84 S.C.L. 192 (S.A.T.).