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You Can Settle Your Insider Trading Case with a Negligence-based Charge

Article By:

David Smyth

This is almost certainly not true anymore. But it was true once! Maybe only once. Back in October 1991, the SEC sued Shared Medical Systems, a Pennsylvania health care information services company and three of its officers and directors: the company for financial reporting fraud and the individuals for insider trading, among other things. Here's what the litigation release said about the insider trading piece:

> The Commission's Complaint alleges that [James] Macaleer, the chairman and chief executive officer of SMS, [James] Kelly, the former executive vice president, treasurer, and secretary of SMS, and [Clyde] Hyde, a former director of SMS, received nonpublic information during 1986 and early 1987 which disclosed a decline in SMS' historic annual growth rate of 20%. Between October and December 1986, while in possession of this information, they sold a total of more than 157,300 shares of SMS stock. Macaleer is also charged with causing the sale of over 22,000 shares of SMS stock from his children's trust and Uniform Gift to Minors Act accounts. The defendants sold their stock at prices ranging from $35 to $ 41.875 per share. After public disclosure of this information, the stock price dropped to $27 per share.

As they typically do, the charges include alleged violations of Section 10(b) of the Exchange Act and Section 17(a) of the Securities Act. As to Section 17(a), the complaint didn't specify Section 17(a)(1) (which is scienter-based) or Sections 17(a)(2) or (3) (which are negligence-based). The complaint, filed in the Eastern District of Pennsylvania, was settled as to Hyde. The other defendants litigated, and filed a motion to dismiss that was denied in August 1992.

It's hard to know what happened over the next 18 months, but the SEC appears to have slowly tired of the fight. In February 1994, the Commission dismissed all charges against Kelly, and replaced the complaint against Shared Medical Systems with a cease-and-desist order as to Section 13(a) of the Exchange Act (negligence-based) and related rules. An amended complaint reinstated the insider trading claims against Macaleer and dropped claims that he had aided and abetted the company's accounting violations. Macaleer moved to dismiss again, and lost again in May 1994.

By June, it was all over. Macaleer settled, in at least two interesting ways. First, the final litigation release noted he “admitted, that, while in possession of [material, nonpublic] information, Macaleer sold SMS stock and thereby avoided losses he otherwise would have incurred.” It’s not shocking that the final settlement would include an admission of liability after this extensive litigation, but that was unusual in that pre-Mary Jo White era. Second, though, the fraud charges were gone. Macaleer admitted only to violations of Section 17(a)(3), not Section 10(b) or Section 17(a)(1).

I don’t think that has happened in an insider trading case before or since. It’s really quite remarkable that Macaleer was able to back the SEC down that way. I would love to know of other instances where an insider trading case was settled on similar terms. Lexis tells me there aren’t any, but maybe I’m missing some.

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