Research Handbook on Insider Trading

Edited by **Stephen M. Bainbridge**

RESEARCH HANDBOOKS IN CORPORATE LAW AND GOVERNANCE

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Stephen M. Bainbridge

University of California, Los Angeles, USA

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Contents

List of figures viii
List of tables ix
List of contributors x

1. An overview of insider trading law and policy: an introduction to the *Research Handbook on Insider Trading* 1
Stephen M. Bainbridge

PART 1 US LAW AND POLICY

2. Launching the insider trading revolution: *SEC v. Capital Gains Research Bureau* 33
A.C. Pritchard

3. What were they thinking? Insider trading and the scienter requirement 52
Donald C. Langevoort

4. Entrepreneurship, compensation, and the corporation 67
Henry G. Manne

5. Regulating insider trading in the post-fiduciary duty era: equal access or property rights? 80
Stephen M. Bainbridge

6. The Facebook effect: secondary markets and insider trading in today's startup environment 99
Stephen F. Diamond

7. Regulation FD: an alternative approach to addressing information asymmetry 112
Jill Fisch

8. Decision theory and the case for an optional disclosure-based regime for regulating insider trading 130
Thomas A. Lambert

PART 2 STUDIES OF SPECIFIC DEFENDANTS

9. Applying insider trading law to congressmen, government officials, and the political intelligence industry 153
J.W. Verret

10. What governmental insider trading teaches us about corporate insider trading 166
Sung Hui Kim
11. A portrait of the insider trader as a woman 191
Joan MacLeod Heminway

PART 3 EMPIRICAL RESEARCH

12. Has illegal insider trading become more rampant in the United States? Empirical evidence from takeovers 211
Laura Nyantung Beny and H. Nejat Seyhun
13. The changing demand for insider trading regulation 230
M. Todd Henderson
14. Insider trading: what is seen and what is not seen 251
Alexandre Padilla
15. The political economy of insider trading laws and enforcement: law vs. politics? International evidence 266
Laura Nyantung Beny

PART 4 GLOBAL PERSPECTIVES

Section A Asia
16. The regulation of insider trading in China: law and enforcement 303
Hui Huang
17. Punishing possession—China's all-embracing insider trading enforcement regime 327
Nicholas Calcina Howson
18. Insider trading regulation in Japan 347
J. Mark Ramseyer

Section B Australasia
19. Insider trading in Australia 365
Keith Kendall and Gordon Walker
20. Insider trading law in New Zealand 386
Gordon Walker and Andrew F. Simpson

Section C Europe
21. UK insider dealing and market abuse law: strengthening regulatory law to combat market misconduct 407
Kern Alexander
22. Insider trading in European law 429
Katja Langenbucher

23. Takeover bids and insider trading 449
Matthijs Nelemans and Michael Schouten

Index 469

Figures

8.1	The spectrum of options for regulating stock trading on the basis of material, nonpublic information	137
8.2	The regulatory spectrum, including the proposed approach	143
12.1	SEC enforcement actions, fiscal years 1985, 1990–2011	216
12.2	Cumulative average abnormal returns to target firms	225
12.3	Implied option volatility relative to takeover announcement	227
12.4	Implied option volatility relative to takeover announcement, by sub-period	228
13.1	Percentage of market professionals in SEC case mix	243
15.1	Illustration of possible causal mechanisms	279
18.1	Stock trading value and volume	349
18.2	Number and market value of listed companies	355
23.1	EU target abnormal returns	455
23.2	EU bidder abnormal returns	456
23.3	Annual frequency of toeholds in US targets (1973–2001)	461
23.4	Event-time returns for opportunistic trades	467

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Tables

12.1 Characteristics of the tender offer sample 224
12.2 Characteristics of the options sample 226
15.1 Summary of hypotheses 279
15.2 Description of variables and sources 285
15.3 Comparative experiences 287
15.4 Summary statistics 290
15.5 Correlations 291
15.6 Weibull regressions of expected time to enactment of insider trading legislation 292
15.7 Weibull regressions of expected time to enforcement of insider trading legislation 294
16.1 When was the case heard? 319
16.2 Who was the insider? 319
16.3 What was the inside information about? 320
16.4 How has criminal enforcement been used? 321
18.1 Insider trading enforcement levels 360

1. An overview of insider trading law and policy: an introduction to the *Research Handbook on Insider Trading*

Stephen M. Bainbridge

In most capital markets, insider trading is the most common violation of the securities laws. It is certainly the violation that has most clearly captured the public's imagination. Surely no other corporate or securities law doctrine has provided the plot line of as many crime thrillers and motion pictures as has insider trading.

Insider trading also long ago captured the attention of academic lawyers and economists to a degree few other topics in corporate law or securities regulation can match. As a result, it attracts scholars in fields ranging from pure legal doctrine to empirical analysis to complex economic theory. This volume collects cutting-edge scholarship in all of these areas by many of the leading experts in insider trading law and economics.

Insider trading jurisprudence is strongly skewed towards US law. This emphasis is not mere academic parochialism or chauvinism, however. The USA remains the world's largest capital market. More important for present purposes, the USA was one of the first jurisdictions to ban insider trading and remains the jurisdiction in which the ban is most energetically enforced. To be sure, insider trading bans are now on the books in many jurisdictions and there is growing global emphasis on fighting the practice. A number of the chapters in this volume focus on these developments. Much of the volume nevertheless is appropriately devoted to US law. The long history and highly developed body of US law on the subject suggest that studying the legal doctrine and policy underpinnings of the US prohibition of insider trading will reward study not only for US corporate and securities law scholars, but for those of all countries. Accordingly, this Introduction provides a foundation for the chapters that follow by setting out the basic US legal rules and the policy debate those rules have engendered.

I. ORIGINS OF THE US PROHIBITION

The prohibition of insider trading originally evolved in the USA as a matter of the state law fiduciary duties of corporate directors and officers. Even after the federal government took primary responsibility for securities regulation, following the adoption of the Securities Act of 1933 and the Securities Exchange Act of 1934, federal law continued to largely ignore insider trading until the late 1960s. Since then, however, a complex federal prohibition of insider trading has emerged as a central feature of modern US securities regulation.

Although the modern insider trading prohibition technically is grounded in the federal securities regulation statutes, most notably Rule 10b-5 promulgated by the Securities and Exchange Commission (SEC) pursuant to the authority granted it by

Section 10(b) of the Securities Exchange Act, the prohibition in fact evolved through a series of judicial decisions in a process more closely akin to common law adjudication rather than statutory interpretation. Indeed, change is one of the key distinguishing characteristics of the federal insider trading prohibition. Unfortunately, this process has been rather ad hoc, which has left the doctrine with a number of problems and curious gaps.

A. The Statutory Background

The modern prohibition is a creature of SEC administrative actions and judicial opinions, only loosely tied to the text of the key statutory provision—Securities Exchange Act § 10(b)—and its legislative history. Section 10(b) provides in pertinent part that:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—
> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered . . ., 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 the protection of investors.[1]

Notice two things about the statutory text. First, it is not self executing. Until the SEC exercises the rulemaking authority vested in it by the statute, § 10(b) does nothing.

Secondly, nothing in § 10(b) explicitly proscribes insider trading. To the extent the 1934 Congress addressed insider trading, it did so not through § 10(b), but rather through § 16(b), which permits the issuer of affected securities to recover insider short-swing profits.[2] Section 16(b) imposes quite limited restrictions on insider trading. It does not reach transactions occurring more than six months apart, nor does it apply to persons other than those named in the statute or to transactions in securities not registered under § 12.

If Congress intended in 1934 that the SEC use § 10(b) to craft a sweeping prohibition on insider trading, the SEC was quite dilatory in doing so. Rule 10b-5, the foundation on which the modern insider trading prohibition rests, was not promulgated until 1942, eight years after Congress passed the Exchange Act. The Rule provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
> (a) To employ any device, scheme, or artifice to defraud,
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.[3]

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[1] 15 U.S.C. § 78j(b).
[2] 15 U.S.C. § 78p(b).
[3] 17 CFR § 240.10b-5.

Note that, as with § 10(b) itself, the Rule on its face does not prohibit (or even speak to) insider trading. Indeed, it was not until 1961 that the SEC finally claimed that insider trading on an impersonal stock exchange violated Rule 10b-5.[4]

B. The Disclose or Abstain Rule

The modern federal insider trading prohibition fairly can be said to have begun with the SEC's 1961 enforcement action *In re Cady, Roberts & Co.*[5] Curtiss-Wright Corporation's board of directors decided to reduce the company's quarterly dividend. One of the directors, J. Cheever Cowdin, was also a partner of Cady, Roberts & Co., a stock brokerage firm. Before the news was announced, Cowdin informed one of his partners, Robert M. Gintel, of the impending dividend cut. Gintel then sold several thousand shares of Curtiss-Wright stock held in customer accounts over which he had discretionary trading authority. When the dividend cut was announced, Curtiss-Wright's stock price fell several dollars per share. Gintel's customers thus avoided substantial losses.

Cady, Roberts involved what is now known as tipping: an insider who knows confidential information does not himself trade, but rather informs—tips—someone else, who does trade. It also involved trading on an impersonal stock exchange, instead of a face-to-face transaction. As the SEC acknowledged, this made it "a case of first impression."[6] Although Rule 10b-5 had sometimes been invoked prior to *Cady, Roberts* to deal with insider trading-like issues, those cases typically had involved face-to-face or control transactions rather than impersonal stock market transactions. Notwithstanding, the SEC held that Gintel had violated Rule 10b-5. In so doing, it articulated what became known as the "disclose or abstain" rule: an insider in possession of material nonpublic information must disclose such information before trading or, if disclosure is impossible or improper, abstain from trading.

It was not immediately clear what precedential value *Cady, Roberts* would have.[7] It was an administrative ruling by the SEC, not a judicial opinion. It involved a regulated industry closely supervised by the SEC. Neither the text of the statute nor its legislative history supported—let alone mandated—a broad insider trading prohibition.[8] There was a long line of state law precedent to the contrary.[9]

In this volume, Adam Pritchard argues that the Supreme Court's decision in *SEC v. Capital Gains Research Bureau*[10] could have had a major impact on the development of

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[4] In re Cady, Roberts & Co., 40 S.E.C. 907 (1961).

[5] 40 S.E.C. 907, 1961 WL 3743 (1961).

[6] Id. at *1.

[7] See, e.g., Recent Decision, 48 Va. L. Rev. 398, 403–04 (1962) ("in view of the limited resources of the Commission, the unfortunate existence of more positive and reprehensible forms of fraud, and the inherent problems concerning proof and evidence adhering to any controversy involving a breach of duty of disclosure, there is little prospect of excessive litigation evolving pursuant to [*Cady, Roberts*]").

[8] See Stephen M. Bainbridge, Incorporating State Law Fiduciary Duties into the Federal Insider Trading Prohibition, 52 Wash. & Lee L. Rev. 1189, 1228–34 (1995).

[9] See id. at 1218–27 (analyzing cases).

[10] 375 U.S. 180 (1963).

the law of insider trading post-*Cady, Roberts*. In his account, *Capital Gains* broke ground both in its approach to interpreting the federal securities laws and in its willingness to incorporate fiduciary principles into the law of insider trading. The opinion's influence was short-lived, however, as the Supreme Court reverted to a more textualist approach in securities cases.

In any case, when the Second Circuit turned *Cady, Roberts* into the law of the land in the seminal *Texas Gulf Sulphur* decision,[11] it opted not to rely on fiduciary principles but rather on a purported policy requiring that investors have equal access to information. In March 1959, agents of Texas Gulf Sulphur Co., a mining corporation, began aerial surveys of an area near Timmins, Ontario. Evidence of an ore deposit was found. In October 1963, Texas Gulf Sulphur began ground surveys of the area. In early November, a drilling rig took core samples from depths of several hundred feet. Visual examination of the samples suggested commercially significant deposits of copper and zinc. Texas Gulf Sulphur's president ordered the exploration group to maintain strict confidentiality, even to the point of withholding the news from other Texas Gulf Sulphur directors and employees. In early December, a chemical assay confirmed the presence of copper, zinc, and silver. At the subsequent trial, several expert witnesses testified that they had never heard of any other initial exploratory drill hole showing comparable results. Over the next several months, Texas Gulf Sulphur acquired the rights to the land under which this remarkable ore deposit lay. In March and early April 1964, further drilling confirmed that Texas Gulf Sulphur had made a significant ore discovery. After denying several rumors about the find, Texas Gulf Sulphur finally announced its discovery in a press conference on April 16, 1964.

Throughout the autumn of 1963 and spring of 1964, a number of Texas Gulf Sulphur insiders bought stock and/or options on company stock. Others tipped off outsiders. Still others accepted stock options from the company's board of directors without informing the directors of the discovery. Between November 1963 and March 1964, the insiders were able to buy at prices that were slowly rising, albeit with fluctuations, from just under $18 per share to $25 per share. As rumors began circulating in late March and early April, the price jumped to about $30 per share. On April 16, the stock opened at $31, but quickly jumped to $37 per share. By May 15, 1964, Texas Gulf Sulphur's stock was trading at over $58 per share—a 222 percent rise over the previous November's price. Any joy the insiders may have taken from their profits was short-lived, however, as the SEC sued them for violating Rule 10b-5.

In what quickly became a leading opinion, the Second Circuit agreed with the SEC that Rule 10b-5 had been violated. The court held that when an insider has material nonpublic information the insider must either disclose such information before trading or abstain from trading until the information has been disclosed. Thus was born what is now known as the "disclose or abstain" rule.

The *TGS* opinion rested on a policy of equality of access to information. The court concluded that the federal insider trading prohibition was intended to assure that "all investors trading on impersonal exchanges have relatively equal access to material

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[11] SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir.), cert. denied, 394 U.S. 976 (1968).

information."[12] Put another way, Congress purportedly intended "that all members of the investing public should be subject to identical market risks."[13]

Accordingly, under *TGS* and its progeny, virtually anyone who possessed material nonpublic information was required either to disclose it before trading or abstain from trading in the affected company's securities. If the would-be trader's fiduciary duties precluded him from disclosing the information prior to trading, abstention was the only option.

In *Chiarella v. US*,[14] the United States Supreme Court rejected the equal access policy. Vincent Chiarella was an employee of Pandick Press, a financial printer that prepared tender offer disclosure materials, among other documents. In preparing those materials Pandick used codes to conceal the names of the companies involved, but Chiarella broke the codes. He purchased target company shares before the bid was announced, then sold the shares for considerable profits after announcement of the bid. He got caught and was indicted for illegal insider trading.

Chiarella was convicted of violating Rule 10b-5 by trading on the basis of material nonpublic information. The Second Circuit affirmed his conviction, applying the same equality of access to information-based disclose or abstain rule it had created in *Texas Gulf Sulphur*. Under the equal access-based standard, Chiarella clearly loses: he had greater access to information than those with whom he traded.

The Supreme Court reversed. In doing so, the court squarely rejected the notion that § 10(b) was intended to assure all investors equal access to information. The court said it could not affirm Chiarella's conviction without recognizing a general duty between all participants in market transactions to forego trades based on material, nonpublic information, and it refused to impose such a duty.[15]

Chiarella thus made clear that the disclose or abstain rule is not triggered merely because the trader possesses material nonpublic information. When a 10b-5 action is based upon nondisclosure, there can be no fraud absent a duty to speak, and no such duty arises from the mere possession of nonpublic information.[16] Instead, the disclose or abstain theory of liability for insider trading was now premised on the inside trader being subject to a duty to disclose to the party on the other side of the transaction that arose from a fiduciary relationship between the parties.[17] As applied to the facts at bar, Chiarella was not an employee, officer, or director of any of the companies in whose stock he traded. He worked solely for Pandick Press, which in turn was not an agent of any of those companies. Pandick did work mainly for acquiring companies—not the takeover targets in whose stock Chiarella traded. He therefore had no fiduciary relationship with—and thus no duty to disclose to—those with whom he traded.[18]

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[12] Id. at 847.
[13] Id. at 852.
[14] 445 U.S. 222 (1980).
[15] Id. at 233.
[16] Id. at 235.
[17] Id. at 230.
[18] Id. at 232–33.

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