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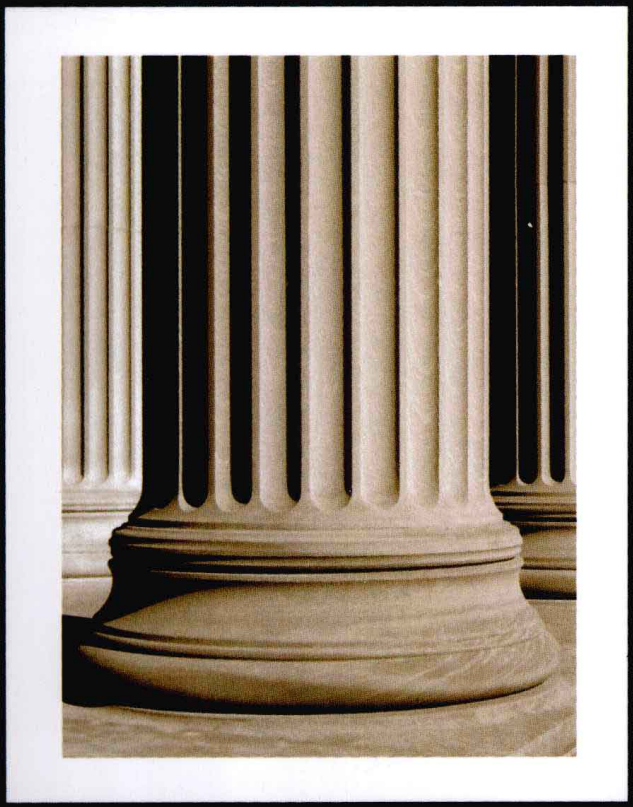
CORPORATE LAW 1

INSIDER TRADING

Stephen M. Bainbridge



Insider Trading

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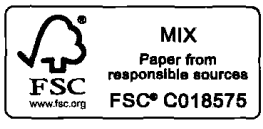

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Introduction

Stephen M. Bainbridge

Today, all countries with developed capital markets impose limits on insider trading, at least in theory. In many respects, however, this is a relatively recent phenomenon, and insider trading enforcement is pursued with a certain ambivalence in many jurisdictions.

A generation ago, the United States was virtually alone in aggressively prosecuting insider trading and even today US insider trading law remains distinctive in the strict nature of its restrictions and in the vigor with which it enforces them. Global restrictions on the practice gradually have emerged only as other jurisdictions converge on the US model. The evolution and policy underpinnings of the US prohibition of insider trading thus reward study not only for US corporate and securities law scholars, but those of all countries.

Insider trading probably is among the most common violations of the federal securities laws. It is certainly the violation that has most clearly captured the public's imagination. Indeed, what other corporate or securities law doctrine provided the plot line of a major motion picture, as insider trading did in Oliver Stone's *Wall Street* (1987)?

As Michael Conant's article in this volume (Chapter 1) explains, however, it was not always so. In the nineteenth century, it was treatise law that officers and directors had no fiduciary obligations with respect to transactions in their company's stock, even if they acted on the basis of inside information gained through their official position. In the early decades of the twentieth century, however, the legal landscape began rapid change. The first tentative step towards the modern prohibition came in *Oliver v. Oliver*,[1] in which the Georgia Supreme Court announced the so-called 'minority' or 'duty to disclose' rule. Under *Oliver*, directors who obtained inside information by virtue of their position held the information in trust for the shareholders. Accordingly, directors had a duty to disclose all material information to shareholders before trading with them.

In *Strong v. Repide*,[2] the US Supreme Court offered a third approach to the insider trading problem. The court acknowledged the majority rule, but declined to follow it. Instead, the court held that, under the particular factual circumstances of the case at bar, 'the law would indeed be impotent if the sale could not be set aside or the defendant cast in damages for his fraud'. The announced doctrine came to be known as the so-called 'special facts' or 'special circumstances' rule, which holds that although directors generally owe no duty to disclose material facts when trading with shareholders, such a duty can arise in – as the name suggests – 'special circumstances'.

The early law of insider trading thus differed dramatically from the more familiar modern federal prohibition. It was a matter of state corporate law, not federal securities regulation. It was premised on the fiduciary duties of directors and officers, not their disclosure obligations. Most importantly, the common law regime was limited to face-to-face transactions. It remained hornbook law that directors and officers did not breach their fiduciary duties when they effected transactions in their company's stock on a stock exchange, even if their trading decisions were

premised on inside information. The concept of outsider liability for use of material nonpublic information – a core part of the modern prohibition – was simply unthinkable.

It is widely assumed that the adoption of the New Deal federal securities laws created the modern insider trading prohibition. Supreme Court Justice Lewis Powell asserted in *Dirks v. SEC*,[3] for example, that '[a] significant purpose of the Exchange Act was to eliminate the idea that use of inside information for personal advantage was a normal emolument of corporate office'. If the New Deal era Congresses in fact so intended, however, the Securities and Exchange Commission (SEC) and the courts were quite lackadaisical in carrying out that intent.

Rule 10b-5, the foundation on which the modern insider trading prohibition rests, was not promulgated until 1942. Nor did the SEC begin using Rule 10b-5 to regulate insider trading on stock exchanges until *In re Cady, Roberts & Co.*[4] The first major judicial precedent did not come until *SEC v. Texas Gulf Sulphur Co.*[5]

In fact, the federal insider trading prohibition is a relatively recent administrative and judicial creation lacking any significant statutory basis. As Michael Dooley observed in his classic article (Chapter 12), 'In regulating insider trading under rule 10b-5 the lower federal courts and the SEC have been operating without benefit of support from the legislative history of the 1934 Act or from the language of section 10(b)'.

Some of the reasons the insider trading prohibition had such an awkward birthing process are suggested by Fleischer, Mundheim, and Murphy's article (Chapter 2). They argued, for example, that that market professionals should have property rights in nonpublic information discovered by such professionals because the information is created by their own efforts. An expansive prohibition on the use of nonpublic information would discourage or even ban their socially beneficial work, as Justice Powell later explained in *Dirks*:[6]

> Imposing a duty to disclose or abstain solely because a person knowingly receives material nonpublic information from an insider and trades on it could have an inhibiting influence on the role of market analysts, which the SEC itself recognizes is necessary to the preservation of a healthy market. It is commonplace for analysts to 'ferret out and analyze information,' ... and this often is done by meeting with and questioning corporate officers and others who are insiders. And information that the analysts obtain normally may be the basis for judgments as to the market worth of a corporation's securities. The analyst's judgment in this respect is made available in market letters or otherwise to clients of the firm. It is the nature of this type of information, and indeed of the markets themselves, that such information cannot be made simultaneously available to all of the corporation's stockholders or the public generally.

Indeed, it seems fair to say that their article importantly influenced Justice Powell's key insider trading opinions.

Those opinions are the *Dirks* case cited above and the earlier decision in *Chiarella v. United States*.[7] In these cases, the Supreme Court flatly rejected the SEC's philosophical position that insider trading regulation should seek to ensure that all investors had equal access to information. Instead, motivated by the concerns raised by commentators like Fleischer, Mundheim, and Murphy (Chapter 2), in these cases Justice Powell, the greatest securities lawyer ever to sit on the Supreme Court, made clear that the SEC's disclose or abstain rule is not triggered merely because a trader happens to possess material nonpublic information. Rather, when a 10b-5 action is based upon nondisclosure, there can be no fraud absent a pre-existing, contractually based, duty to make such disclosure. Moreover, no such duty arises from the mere

possession of nonpublic information. Instead, the so-called disclose or abstain theory of liability for insider trading is premised on the inside trader being subject to a duty to disclose to the party on the other side of the transaction arising from a relationship of trust and confidence between the parties thereto. As Powell explained in *Dirks*:[8]

> We were explicit in *Chiarella* in saying that there can be no duty to disclose where the person who has traded on inside information 'was not [the corporation's] agent, ... was not a fiduciary, [or] was not a person in whom the sellers [of the securities] had placed their trust and confidence.' Not to require such a fiduciary relationship, we recognized, would 'depar[t] radically from the established doctrine that duty arises from a specific relationship between two parties' and would amount to 'recognizing a general duty between all participants in market transactions to forgo actions based on material, nonpublic information.'

Donald Langevoort's and Jonathan Macey's articles (Chapters 3 and 4, respectively) provide the important doctrinal, historical, and policy context necessary to understand these crucial opinions. Of great scholarly interest is Adam Pritchard's article (Chapter 6), which digs into Justice Powell's private papers to provide unique insights into the Justice's thinking and drafting.

Just as there had been nothing historically or doctrinally inevitable about the SEC's preferred policy of equal access, there was nothing inevitable about the Supreme Court's rejection of that standard. The equal access standard was consistent with a trend toward affirmative disclosure obligations and away from caveat emptor that was sweeping across a broad swath of the common law. In rejecting this trend, as Adam Pritchard's article explains, Justice Powell arguably shifted the focus of insider trading liability from deceit to agency. It may have been a sound policy result for the reasons alluded to above, but nothing in the text of the statute or the rule explicitly mandated that shift. As such, judges and regulators with different policy preferences were free to seek ways of end running Powell's formulation.

After its defeats in *Chiarella* and *Dirks*, the SEC in fact began advocating a new theory of insider trading liability that came to be called 'misappropriation'. Its origins are commonly (but incorrectly) traced to Chief Justice Burger's *Chiarella* dissent. Burger contended that the way in which the inside trader acquires the nonpublic information on which he trades could itself be a material circumstance that must be disclosed to the market before trading. Accordingly, he argued, 'a person who has misappropriated nonpublic information has an absolute duty [to the persons with whom he trades] to disclose that information or to refrain from trading'. The majority declined to address Burger's argument, because it had not been presented to the jury and thus could not sustain a criminal conviction.

The way was thus left open for the SEC to urge the lower courts to adopt the misappropriation theory as an alternative basis of insider trading liability. In *United States v. Newman*,[9] employees of an investment bank misappropriated confidential information concerning proposed mergers involving clients of the firm. As had been true of Vincent Chiarella, the Newman defendants' employer worked for prospective acquiring companies, while the trading took place in target company securities. As such, the Newman defendants owed no fiduciary duties to the investors with whom they traded. In this instance, moreover, neither the investment bank nor clients traded in the target companies' shares contemporaneously with the defendants.

Unlike Chief Justice Burger's *Chiarella* dissent, the Second Circuit did not assert that the *Newman* defendants owed any duty of disclosure to the investors with whom they traded or

who had been defrauded by them. Instead, the court held that by misappropriating confidential information for personal gain, the defendants had defrauded their employer and its clients and that that fraud sufficed to impose insider trading liability on the defendants with whom they traded.

Like the traditional disclose or abstain rule, the misappropriation theory thus required a breach of fiduciary duty before trading on inside information became unlawful. Under the misappropriation theory, however, the defendant need not owe a duty either to the investor with whom he traded or to the issuer of the traded securities. Instead, the misappropriation theory applied when the inside trader violated a fiduciary duty owed to the source of the information.

Richard Painter, Kimberly Krawiec, and Cynthia Williams' (Chapter 5) and Adam Pritchard's (Chapter 6) articles trace the development and eventual Supreme Court acceptance of the misappropriation theory. As their articles recount, the misappropriation theory fits awkwardly at best into traditional securities regulation concepts. Did the deceit, if any, worked by the misappropriator on the source of the information constitute deception as the term is used in Section 10(b) and Rule 10b-5? If so, did such deceit occur 'in connection with' the purchase or sale of a security, as required by the statute and rule? There were good reasons to think the answer to both of those questions was 'no'. Indeed, Pritchard's analysis of Justice Powell's papers demonstrates quite convincingly that Powell would have rejected the misappropriation theory if given the opportunity.

Nonetheless, when finally presented with the issue, the Supreme Court validated the misappropriation theory in *U.S. v. O'Hagan*,[10] holding that the theory is 'designed to "protec[t] the integrity of the securities markets against abuses by 'outsiders' to a corporation who have access to confidential information that will affect th[e] corporation's security price when revealed, but who owe no fiduciary or other duty to that corporation's shareholders."' The decision has been widely criticized, with the complaints registered by Painter and his coauthors being broadly representative of the principal critiques.

The Supreme Court trilogy is so central to the story of the insider trading prohibition because no federal statute or regulation defines what constitutes insider trading. No statute or SEC regulation defines insider trading. Neither Section 10(b) nor Rule 10b-5 use the term insider; nor do they make any other explicit reference to the concept. Instead, the task of differentiating legal from illegal trading by insiders – and, for that matter, the definition of who is an insider – has been left to a process of common law adjudication as courts fill the interstices of federal securities law. Attempts to distill that process down into a manageable definition have generally been unsuccessful. Consider, for example, one common statement of the principle: 'Insider trading is a term of art generally meaning, or referring to, unlawful trading by someone, whether or not the person is a true corporate insider, possessing material, nonpublic information about publicly traded securities.'[11] The key problem with that effort is that it leaves undefined the key issue; namely, when insider trading is 'unlawful'. Instead, as we have seen, what emerged from the evolving common law process was not a single definition, but rather a number of distinct bases on which insider trading liability may be premised.

The absence of a statutory definition reflects a conscious choice by Congress and the SEC. In rejecting a proposal to include a definition of insider trading in the Insider Trading Sanctions Act of 1984, for example, the House Committee on Energy and Commerce asserted that the common law was sufficiently developed to warn traders of what was wrongful and that the problem of drafting a workable definition was so complex that 'any effort to define insider

trading would result in, at best, a slightly less generalized rule than 10b-5 and, at worst, a rule that leaves gaping holes "large enough to drive a truck through."'

While Congress refused to define insider trading in the 1984 statute, it chose that occasion to significantly ramp up the already draconian penalties associated with insider trading violations. In particular, that statute created a treble money civil fine, pursuant to which defendants can be ordered to pay up to three times the profit earned or loss avoided from their trading. Donald Langevoort's second article in this volume (Chapter 7) examines the 1984 statute in detail.

Congress returned to the question of insider trading penalties in The Insider Trading and Securities Fraud Enforcement Act of 1988, which made them even more draconian. For example, the 1988 Act increased the criminal fine from a maximum of $100 000 to $1 million per count. It extended civil liability to controlling persons. It also expressly validated liability for tippers. Lawrence Mitchell's article (Chapter 8) explores the relation between these statutes and the common law of insider trading.

The last two parts of this volume turn to the underlying policy question: why is insider trading illegal? To say that this debate is voluminous is a gross understatement. The articles chosen for this volume are intended to provide an overview of the core elements of the debate as it has evolved over time.

One exaggerates only slightly to say that Henry Manne's 1966 book *Insider Trading and the Stock Market*[12] stunned the corporate law academy by daring to propose the deregulation of insider trading. Indeed, as illustrated by Roy Schotland's review (Chapter 10), the response by many traditionalist scholars was immediate and vitriolic.

As summarized in his *Harvard Business Review* article (Chapter 9), Manne identified two principal ways in which insider trading benefits society and/or the firm in whose stock the insider traded. First, he argued that insider trading causes the market price of the affected security to move toward the price that the security would command if the inside information were publicly available. If so, both society and the firm benefit through increased price accuracy. Second, he posited insider trading as an efficient way of compensating managers for having produced information. If all of this is true, then the firm benefits directly (and society indirectly) when insider trading is permitted because managers have a greater incentive to produce additional information of value to the firm.

As illustrated by Schotland's review, Manne's work met with what David Haddock aptly calls 'vociferous hostility' from most more traditionally minded legal scholars.[13] Indeed, one might have thought Manne had insulted motherhood and apple pie. In 'Insider Trading and the Law Professors' (Chapter11), Manne replied to their arguments. Manne opened by pointing out the dearth of serious criticism of the SEC by legal academics prior to his work. As he observed, most prior legal academics held 'a firm and unwaivering conviction that what the SEC says is right'.

Turning to the merits, in 'Insider Trading and the Law Professors' Manne offered his most complete defense against the various counter-arguments lodged against *Insider Trading and the Stock Market*. Among the arguments Manne rebuts in this article that one nevertheless still sees in the literature are:

- *Harm to investors.* Many of Manne's critics argued that an investor who trades in a security contemporaneously with insiders having access to material nonpublic

information suffer in that the investor sold at the wrong price – i.e., a price that does not reflect the undisclosed information. If a firm's stock currently sells at $10 per share, but after disclosure of the new information will sell at $15, a shareholder who sells at the current price thus allegedly suffered a $5 loss. As Manne points out, however, this claim is fundamentally flawed. It is purely fortuitous that an insider was on the other side of the transaction. The gain corresponding to shareholder's 'loss' is reaped not just by inside traders, but by all contemporaneous purchasers whether they had access to the undisclosed information or not.

- *Delay*. Manne's critics also claimed that, if insider trading were deregulated, it would create incentives for managers to delay the transmission of information to superiors. As Manne explains, however, given the rapidity with which securities transactions can be conducted in modern secondary trading markets, any such delay is likely to be trivial, especially since the manager often will wish to strike while the proverbial iron is hot.
- *Manipulation*. Manipulation of stock prices, as a form of fraud, harms both society and individuals by decreasing the accuracy of pricing by the market. Some of Manne's critics argued that if managers are permitted to trade on inside information they have a strong interest in keeping the stock pricing stable or in moving it in the correct direction while they are trading. Therefore, they have a strong incentive to use manipulative practices. Manne's principal response is that the costs of producing perfect compliance with a prohibition against insider trading are unacceptably high.
- *Investor confidence*. Like many modern proponents of the insider trading prohibition, Manne's critics argued that insider trading erodes investor confidence. If any investors believe that the SEC's enforcement actions have driven insider trading out of the markets, however, they require psychiatric rather than legal assistance. Nevertheless, the stock market remains robust. Manne thus concludes that insider trading does not seriously threaten the confidence of investors in the securities markets.

In addition to defending his prior arguments, Manne also made an important positive clarification in this article: 'all I am pleading for is a *rule of full disclosure*.'

As Manne recognized in his analysis of the incentive effects of insider trading on corporate agents, the question of insider trading really can be seen as one about forms of compensation. Michael Dooley explained the importance of this insight on Manne's part as follows:

> Manne's principal argument was that insider trading was primarily a matter of contract between the corporation and its officers and directors. The parties might or might not agree to the use of confidential information as a form of compensation ... Taking its cue from state corporation law, the [SEC should] have realized that the common law has always adopted a hands-off approach with regard to the amount of explicit compensation paid to corporate executives. However, the agency has also taken a strict stance against hidden forms of implicit compensation and required divestiture of corporate opportunities, disgorgement of profits made from unauthorized use of corporate property and the like. This arrangement of rules – lenient with regard to explicit compensation and strict with regard to secret compensation – is eminently sensible. Shareholders are the best judges of the value of their executives' contributions to the corporation and are entitled to know how much they are paid. Shareholders might well, as Manne argued, be indifferent to the forms of compensation, but they would certainly be interested in the total amount of compensation paid to executives in addition to their announced salaries and bonuses.
>
> Since the SEC already had the authority to require disclosure of compensation, they had ample grounds on which to prosecute *Texas Gulf Sulphur* as a violation of the proxy rules. Subsequently,

> and without straining its authority, the agency might have amended the disclosure regulations under the proxy rules to require an *ex ante* announcement by the corporation as to whether insiders would be permitted to trade on inside information together with some sort of *ex post* settling up by the insiders themselves.[14]

It seems clear that Manne would have been eminently satisfied with such a result.

The decades that followed have seen various refinements of the debate being offered by many scholars. Michael Dooley (Chapter 12), for example, turned the focus to the failures of the process by which insider trading laws were enforced. His goal was to divine the optimal level of enforcement, if any. As he explained: 'It is the thesis of this article that correctly assessing the demand for insider trading restrictions determines not only the quantity of enforcement but also the legitimacy of the substantive regulation itself. That is, the article argues that investors must be the primary beneficiaries of insider trading regulation to justify the existence of the regulation.' As it stood (and still stands), the insider trading prohibition failed that test.

In Chapter 13, Carlton and Fischel proposed a refinement of Manne's compensation argument. Like Manne, they believed that advance payment contracts fail to compensate managers for innovations. The firm could renegotiate these contracts later to account for innovations, but renegotiation is expensive and thus may not occur frequently enough to provide appropriate incentives for entrepreneurial activity. Carlton and Fischel therefore identified as one of the advantages of insider trading the ability of a manager to change his compensation package without continually renegotiating his contract. By trading on the new information, the manager self-tailors his compensation to account for the information he produces, increasing his incentive to develop valuable innovations. Since insider trading provides the manager with more certainty of reward than other compensation schemes, they further argued, it also provides superior incentives.

Larry Ribstein's contribution to this volume (Chapter 14) tackles the question of whether insider trading should be a matter of federal or state law. According to Ribstein, the *O'Hagan* court correctly concluded that insider trading could be a form of theft by which the trader infringes on the source of the information's property rights therein. However, he argued, the Court ignored its federalism precedents and the prospect that state law is better positioned to protect property rights in information. 'State law already offers better-developed legal rules regarding property rights. Because of state law's greater potential to benefit from jurisdictional competition and legal evolution, state courts and legislators are more likely than federal lawmakers to devise efficient legal rules for protecting private information.'

The concluding article in this volume, Chapter 15 by Stephen Bainbridge, is a broad literature review of the policy debate. He points out that insider trading is one of the most controversial aspects of securities regulation, even among the law and economics community. One set of scholars favors deregulation of insider trading, allowing corporations to set their own insider trading policies by contract. Another set of law and economics scholars, in contrast, contends that the property right to inside information should be assigned to the corporation and not subject to contractual reassignment. Deregulatory arguments are typically premised on the claims that insider trading promotes market efficiency or that assigning the property right to inside information to managers is an efficient compensation scheme. Public choice analysis is also a staple of the deregulatory literature, arguing that the insider trading prohibition benefits market professionals and managers rather than investors. The argument in favor of regulating

insider trading traditionally was based on fairness issues, which predictably have had little traction in the law and economics community. Instead, the economic argument in favor of mandatory insider trading prohibitions has typically rested on some variant of the economics of property rights in information.

Notes

1. 45 S.E. 232 (Ga. 1903).
2. 213 U.S. 419 (1909).
3. 463 U.S. 646, 653 n.10 (1983).
4. 40 S.E.C. 907 (1961).
5. 401 F.2d 833 (2d Cir. 1968), cert. denied, 394 U.S. 976 (1969).
6. 463 U.S. at 658–59.
7. 445 U.S. 222 (1980).
8. 463 U.S. at 654–55.
9. 664 F.2d 12 (2d Cir. 1981), cert. denied, 464 U.S. 863 (1983).
10. U.S. 642 (1997).
11. Symposium, *Insider Trading: Law, Policy, and Theory After O'Hagan*, 20 Cardozo L. Rev. 7, 9 (1998).
12. Manne, Henry (1966), *Insider Trading and the Stock Market*, New York: Free Press.
13. David D. Haddock, *Academic Hostility and SEC Acquiescence: Henry Manne's Insider Trading*, 50 Case W. Res. L. Rev. 313 (1999).
14. Michael P. Dooley, *Comment from an Enforcement Perspective*, 50 Case W. Res. L. Rev. 319, 321–22 (1999).

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Origins and Development of Insider Trading Law