

REGULATION OF INSIDER TRADING: RETHINKING SEC POLICY RULES

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Introduction

The \$100 million fine levied by the Securities and Exchange Commission (SEC) against Wall Street trader Ivan Boesky is the most spectacular development in the recent crackdown on insider trading. The regulation of insider trading is apparently becoming an increasingly important part of the SEC's regulatory activities. The Commission has stepped up domestic enforcement of the ban on insider trading and has attempted to limit the use of overseas exchanges to consummate insider trading in American securities (*Wall Street Journal*, 24 September 1986, p. 2). Although the effectiveness of the current crackdown cannot yet be determined, the Boesky fine, and other severe penalties that have emerged from the ongoing investigation of the insider trading ring centered around investment banker David Levine, signal the determination of the SEC to significantly curtail illegal insider trading. Although the current increase in regulatory fervor may die out to be replaced by a policy of benign neglect, in the short run it is highly likely that the SEC will succeed in reducing the amount of insider trading. The desirability of such a decrease, however, is questionable for many reasons.

One reason is that the support of the general public for a continued ban on insider trading is quite superficial. In a recent poll in *Business Week* (23 August 1986, p. 74), 52 percent agreed that insider trading should continue to be illegal. Yet, 53 percent of those polled would buy stock based on a tip from a friend who has inside information. Of those who would not buy the stock, 37 percent stated that the reason for not purchasing was that the tip might be wrong. About

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half of those who would not trade on insider information cited illegality or immorality as the reason. In sum, the poll indicates that approximately 70 percent of the public would in fact trade on insider information if they found it profitable to do so.¹ Clearly, insider trading does not induce the same opprobrium as embezzlement or fraud.

Academics share the public's ambivalence toward trading on insider information. Although discussions in the popular press imply that insider trading is universally regarded as bad and appropriately illegal, the issue is anything but settled in the academic literature. For example, Henry Manne's (1966) analysis is the classic statement of why allowing insider trading is an efficient method of compensating entrepreneurs. Manne (1970, 1985) and others have subsequently bolstered the case for efficiency by citing the lack of hostility in the attitude of firms toward trading by insiders. In particular, the argument that the shareholders of firms are harmed by the trading of executives is difficult to reconcile with the absence of widespread private restrictions on insider behavior. Few firms restrict insider trading beyond what is required by the SEC (Dooley 1980; Easterbrook 1981). Moreover, the common law has permitted insider trading, except in cases involving fraud. The behavior of different political units provides further evidence that insider trading does little to harm investors or firms. States, who effectively compete for incorporations, do not appear to gain any competitive advantage over one another by prohibiting insider trading (Carlton and Fischel 1983; Easterbrook and Fischel 1984). Other countries for the most part do not vigorously regulate insider trading (Rider and Ffrench 1979), although recent developments on the London Stock Exchange appear to be leading to tougher rules against the practice.

The academic literature implies that the case for regulation is not overwhelming. Because insider trading moves the market prices of stock in the correct direction, it can be defended on grounds of efficiency. Arguments can be made that inefficiencies may arise due to withholding information or the moral hazard problem, but most economists find the case that insider trading is efficient to be stronger than the case that it is not (Carlton and Fischel 1983). Another justification for regulation is that it protects the property rights of the firm in inside information (Scott 1980). The property rights argument does

¹That is to say, 53 percent of the public would buy stock on inside information. Of those who would not buy on inside information (47 percent), 37 percent apparently would buy if they thought the information was correct. Hence, $53\% + (47 \times 37)\% = 70.4\%$ percent would buy on inside information if they believed they would profit from it.

not necessarily mean that the SEC should regulate insider trading. Furthermore, it is seldom used by supporters of regulation. Most of the opposition to insider trading rests on grounds of fairness. It is argued that investors with insider information possess an unfair advantage over other investors. The prohibition of insider trading is thus deemed necessary to keep the game fair. As with a gambling casino, the odds in the stock market must be made the same for all players. Moreover, if some players regard the game as unfair, they may refuse to invest. The casino analogy may be an attractive way to view the stock market. The SEC nevertheless faces enormous difficulties in any attempt to realize the ideal of a stock market where no one benefits from inside information. The difficulties stem from the many different ways to profit from inside information. Here, we focus on some of the distortions caused by the current partial policing of insider trading.

The Gains from Inside Information

The insider trading that receives most public attention involves information of the "bombshell" variety: mergers, hostile takeovers, and mineral discoveries (Carlton and Fischel 1983). The classic case is that of *SEC v. Texas Gulf Sulphur Co.*, where insiders traded on the knowledge of mineral discoveries before those discoveries were announced to the general public. Recent well-publicized cases have involved stock purchases by speculators on the eve of a takeover. The importance of bombshell inside information has often obscured the fact that gains from insider trading are simply the most publicly visible of the gains from insider trading. Investors with access to inside information make above average returns in other ways.

One source of insider gains is trading on the basis of ordinary insider information. Ordinary information could include inside knowledge of the ability of managers. For example, an executive might know that a new chief executive officer is extraordinarily competent and buy stock on that knowledge, gaining from the appreciation brought about by the new boss. A feud between two important corporate officers could lead to gains to insiders who sell on the expectation that the feud will affect the firm's performance. Countless other bits of information can be used by insiders to outperform the market. Gains from ordinary inside information are not as spectacular as those arising from advance information on a hostile takeover bid. Yet, the aggregate gains from ordinary insider trading may well exceed gains from the more glamorous bombshell trades.

Potential gains to insiders are not restricted to trading gains. It is also possible for insiders to profit from not trading.² Although Manne and others have mentioned insider nontrading (and the potential profits involved), the practice is largely unknown to outsiders. It can best be described with a few hypothetical case studies.

First, consider the case of Ms. B., a highly placed corporate executive at ABD, Inc. Ms. B. has substantial holdings of ABD stock and, before a mid-morning meeting, she had planned to sell some of her holdings to take profits on a recent rise to \$40 a share. At the meeting, she learns of a friendly takeover bid from KNW, Inc. at \$60. Ms. B., acting on information not yet in the public domain, holds on to her stock after the meeting. Later, she sells out for \$60, reaping a hefty profit from her earlier nontrade. Now, if she had purchased more shares in ABD prior to the public disclosure of the takeover she would have violated existing codes. Although she did not violate any codes, by not going through with a planned sale she clearly used inside information for personal gain. Had she sold at \$40, the purchasers would have reaped the gain from the rise to \$60.

Next, there is the case of Lloyd R., a stockbroker who has recently lost several clients to a discount brokerage house. Lloyd somehow manages to acquire advance information on the planned takeover of ABD. He also has discovered (more inside information) that his biggest client is about to desert him for a discount broker. He phones the client who has large holdings of ABD, and tells her not to sell. The client holds, makes a huge gain, and, seeing the benefits of a full-service broker, decides not to take her business to the discount broker. Both Lloyd and his client have gained by not trading based on inside information.

The point is that nontrading based on inside information is as much an abuse of inside information as is insider trading. The essential identity of the two practices can be seen in our final case study. Mr. Q., an investment banker, has been hearing rumors that KNW is planning to merge with CYR, Inc. He is planning to purchase a large block of CYR stock on the basis of the rumor and his own judgment that the merger makes economic sense. Before making the purchase, he phones a source at KNW who tells him that ABD and not CYR is the target. He purchases ABD instead and makes substantial gains. Although, the purchase of ABD on inside information is illegal, the nonpurchase of CYR is perfectly legal. Yet, the same inside information is involved in both decisions. Indeed, it is *the same decision*. The decision to purchase ABD is simultaneously a decision not to

²The rest of this paragraph and the next two paragraphs are taken from Kelly (1986).

purchase CYR. Both the trade and the nontrade are "unethical," but only the trade is illegal. The case of Mr. Q. neatly illustrates the illogic of singling out insider trading for legal action while allowing insider nontrading to take place with impunity.

Tens of thousands of executives in thousands of publicly held companies have access to internal information every day. Given the arguments above it seems probable that gains from high visibility events represent only the tip of the iceberg of insider trading gains. Since all insiders are required to report all trades in their firms' shares to the SEC, there is ample data to test the hypothesis that insiders trading in such shares make abnormal returns. Empirical evidence indicates that they do (Seyhun 1986). However, supporters of insider trading regulations have produced no empirical evidence—at least, of which we are aware—to demonstrate that the few high visibility cases that are feasible to prosecute in fact represent the kind of activities that generate the major part of the abnormal returns to insiders. Indeed, based on the arguments above, it seems more probable that they represent the minor part. The remainder of the paper is devoted to the implications of the SEC's practice (as a matter of feasibility) of prosecuting only highly selective cases of insider trading gains.

Problems of Regulation

The SEC currently regulates insider trading under sections 10(b) and 16(b) of the Securities Exchange Act, as well as Rule 14e-3 and Rule 10b-5, adopted by the Commission. Rule 14e-3 regulates trading by insiders when a tender offer is involved; Rule 10b-5 is more general and is the one usually invoked in cases of insider trading. Although it is a violation of Rule 10b-5 to trade on the basis of any material nonpublic information, in practice enforcement is limited to the use of bombshell information. In particular, takeovers have become the principal area of investigation and enforcement. The SEC has not attempted to prevent profiting from the possession of ordinary inside information. Insiders are also free to profit from non-trading. The costs of regulating trading on the basis of ordinary information and nontrading are apparently sufficiently large relative to the benefits to prevent such regulation. Yet, the unregulated gains from the use of inside information probably account for most insider gains. The regulation of insider trading must therefore not be regarded as an attempt to eliminate all or even most of the gains made by investors with material nonpublic information. Rather, regulation aims to reduce or perhaps eliminate one particular type of insider

trading. Indeed, the recent activities of the SEC have been devoted to preventing the illegal acquisition and use of inside information by outside speculators.

The issue involved in the regulation of insider trading, then, is not whether to allow insiders to profit from their information; most insider income from equities is legal. The issue is whether to outlaw gains from particular types of inside information, especially advance knowledge of takeover bids. The desirability of current SEC regulations must therefore be judged on the desirability of partial regulation.

To those who believe that insider trading is efficient, there is of course no justification for the regulations unless they view the practice as unfair. It may nevertheless also be true that those who believe that insider trading is unfair or inefficient cannot justify the existing regulations. The absence of justification stems from the partial application of the rule prohibiting insider trading. Partial application of the prohibition may lead to behavior aimed at avoiding illegality while continuing to profit from inside information. One possibility is that those with potential access to inside information on certain stocks will adjust their portfolios so as to be in position to gain. The distortions caused by portfolio adjustments motivated solely by a desire to avoid prosecution for insider trading may cause substantial economic inefficiencies.

Possibly the most important inefficiency of current regulations is due to the distortion of managerial incentives. Suppose that KNW, Inc. has merger discussions already under way with both ABD and CYR. Now, suppose that a merger with ABD makes more economic sense. The manager of KNW (or perhaps the investment banker setting up the deal) owns no ABD stock but has substantial holdings in CYR. Insider trading is not permitted in takeover bids, so the manager cannot buy ABD. He may therefore recommend merging with CYR, because no restrictions are placed on gains from nontrading. The resulting merger generates more benefits to the manager (or investment banker), despite its inferiority to a merger with ABD. The stockholders in KNW and CYR suffer because of the suboptimal merger.³

Consider another aspect of the problem. According to Annette Poulsen and Gregg Jarrell (1986), the increasing value of the target firm's stock price allows shareholders to gain from tender offers. This is true regardless of whether the tender offer is hostile or friendly.

³Although the behavior described in this paragraph will most assuredly not occur in every case, because of company loyalty and the harm done to a manager's career by poor decisions, current regulations increase the likelihood of such behavior.

But if the tender offer is successfully fought off, shareholders of the target firm ultimately receive no net gain. Of course, if the tender offer fails, management in the target firm keeps its job. David Kass (1986) argues that an important determinant of whether a tender offer is accepted is the dollar amount of stock held by management of the target firm. The larger this amount the more the gain to management from accepting the offer. If insider trading were legal, management of the target firm could purchase stock in the company and profit sufficiently to cover the loss of salary and position due to the takeover. Under current laws, insider knowledge only benefits management if large blocks of stock are already held. Shareholders (unless management buys them out at a premium) lose if management, influenced by lack of stock ownership, successfully opposes takeovers to preserve its own position. Indeed, one could argue that the increasing interest of the SEC in restricting insider trading is leading to new and widely criticized innovations for managers to keep out takeovers, such as golden parachutes and poison pills.⁴ Again, there is a distortion of economic activity. The asymmetric legal treatment of insider nontrading and insider trading biases successful tender offers toward firms where management already holds (and with insider knowledge has substantial incentives not to prematurely sell) a large portfolio of its own company's stock.

The current *de facto* partial illegality of insider trading may therefore at best only mitigate the gains to insiders. Indeed, it may simply redirect how these gains are obtained. Managers and investment bankers have an incentive to arrange takeovers based on their own portfolios instead of attempting to maximize profits for shareholders. And managers have incentives to generate the sort of inside information that will increase the value of their existing portfolios. These distortions of managerial behavior may substantially reduce economic efficiency without necessarily reducing the gains to insiders.

Conclusion

Insiders will profit from material nonpublic information; the prevention of these profits is beyond the power and the will of the SEC. The current campaign against insider trading by arbitrageurs is typical of the SEC policy of emphasizing particular highly visible activities. Most gains from insider information continue to be legal or at least overlooked. Current policy merely introduces additional distortions into the market.

⁴Golden parachutes may, however, facilitate takeovers by reducing the incentive of management to oppose a change in the ownership and control of the firm.

We believe that a rethinking of SEC policy rules is in order. Although cases of fraud or violation of contracts should not be ignored by the SEC (or some other enforcement agency), insider trading in and of itself might well be left alone. The prohibition of insider trading could be left to the discretion of individual firms. Current regulations do not increase the fairness of investment markets; they serve only to introduce new distortions while diverting attention from other important "offenses."

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