

Cato Institute Policy Analysis No. 101: SEC's Insider Trading Proposal: Good Politics, Bad Policy

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Executive Summary

Although the ethical and economic aspects of insider trading regulation have been discussed at length, only recently have commentators begun to examine the political aspects of this practice.[1] The virtual total neglect of the political side of the story is particularly curious in light of the fact that regulation of insiders' trading practices has become a highly politicized issue and has prompted numerous hearings[2] and bills[3] in Congress.

At present, a battle for the right to regulate insider trading is being fought among Congress, the regulators at the SEC, and the federal judiciary. Each of these organizations has an institutional (if not political) interest in regulating the trading practices of insiders, and those interests are reflected in the regulations and proposals they have promulgated.

Not surprisingly, the federal judiciary, insulated as it is by the relative independence from political pressures brought about by Article III of the Constitution, has promulgated the most sensible--though not thoroughly sensible--rules about insider trading.[4] It is dissatisfaction with these rules among powerful political constituencies that has led the SEC and Congress to attempt to abrogate the clear rules developed by the Supreme Court and the lower federal courts over the last several years.

With an aim of exploring more deeply the political aspects of the current debate on insider trading, this essay begins by examining the political implications of the rules on this subject that were generated by the Supreme Court in *Chiarella v. United States*[5] and *Dirks v. Securities and Exchange Commission*[6] and clarified in a series of lower court decisions. These two decisions brought both clarity and coherence to the law of insider trading, which previously had been a bog of confusion. The decisions also represented major defeats of the SEC's concerted attempts to use the rules against insider trading to advance its own bureaucratic ends.

Powerful special-interest constituencies of Congress and the SEC were dissatisfied with the rules generated by the Supreme Court. Their dissatisfaction led to the promulgation of the SEC's recently proposed compromise statute, which purports to define the crime of insider trading for the first time.[7]

The proposed statute reflects the interests of those constituencies rather than the proffered public-interest goal of protecting the "fairness, efficiency and integrity of the Nation's securities markets." [8] Judge-made law of insider trading evolved from the enactment of SEC Rule 10b-5 to the Supreme Court's decisions in *Chiarella* and *Dirks*. [9] The courts gradually moved from vague, incoherent "fairness" justifications of insider trading law toward precise, intellectually defensible contract-based justifications of such law. Recently, however, the locus of lawmaking on the subject of insider trading has shifted from the federal courts to Congress. The result has been the triumph of politics

over principle.

The Ramifications of Chiarella and Dirks

Until the Reagan administration, elected officials left the development of insider trading rules to the SEC and the federal courts. During the 1980s, the Supreme Court, in a major philosophical split with the SEC, rejected the notion that those in possession of material nonpublic corporate information owe a general duty to the marketplace that requires them to disclose that information. In its place, the Supreme Court moved toward adopting a property-rights-based theory of insider trading liability that was profoundly threatening to the SEC. It was this shift in focus that led to the plea for Congress to act and alter the way that insider trading practices are regulated.

The Supreme Court's Insider Trading Rules

Prior to the Supreme Court's decision in Chiarella, the law on insider trading was a morass.[10] It not only lacked a clear meaning; it even lacked a unifying theory of liability upon which enforcement could be based. The SEC appeared perilously close to enacting a rule that would penalize any trader who dared to consummate a securities transaction of any kind on the basis of an informational advantage over his trading partner, a theory that would bring the capital markets to ruin if implemented.

Happily, the Supreme Court came to the rescue of the financial marketplace, at least for a time, when it decided Chiarella. The defendant in that case, Vincent Chiarella, stood accused in criminal court of trading stock on the basis of information acquired in the course of his employment at Pandick Press, a financial printer. Chiarella was able to deduce the identity of companies that were about to become targets of public tender offers for their shares by decoding the disclosure documents he was helping to prepare. Significantly, although it left no doubt that Chiarella could be found guilty under this constellation of facts, the Court, speaking through Justice Powell, rejected the SEC's contention that all traders owe a general duty of disclosure to all participants in market transactions, regardless of how they have obtained the information upon which they are trading.[11]

By squarely rejecting the possibility, left open by the Second Circuit's flawed (but highly influential) opinion in Texas Gulf Sulphur,[12] that the law required equality of information among all traders, the Court ushered in a new era of certainty and rationality in the realm of insider trading regulation.

Not only did the Court dismiss the idea that the law should attempt to achieve a general parity of information among traders, it rejected the possibility, also left open by Texas Gulf Sulphur, that a purchaser or seller of stock automatically acquires a duty to disclose whenever he enters into a transaction on an organized stock exchange.[13]

Acceptance of either of these theories of liability would have had disastrous consequences for the financial marketplace. The capital markets are driven by the quest for information. Without the ability to profit from an informational advantage, traders would have no incentive to expend the resources necessary to obtain and assimilate firm-specific information. Without such information, the capital markets would not behave in a rational manner and would not serve as an adequate guide for the allocation of society's investment resources. Thus, the Supreme Court, by rejecting these earlier theories of liability, performed an important service to the capital markets and to the national economy.

In place of the dangerous incoherence that preceded the Chiarella opinion, the Court offered a new theory, based on fundamental notions of property rights, to justify sustaining the law's objections to the trading activities of insiders. The Court ruled that a specific contractual relationship of a fiduciary nature is a necessary prerequisite to liability under the SEC's notorious Rule 10b-5.[14]

In Chiarella, the Court made it clear that there is no obligation to disclose "where the person who has traded on the inside information was not the corporation's agent . . . was not a fiduciary, was not a person in whom the sellers had placed their trust and confidence." [15] And because Chiarella was the subject of a criminal prosecution and the new, fiduciary duty-based theory of liability was not articulated to his jury, the Court ruled that his conviction could not stand. Subsequent cases, particularly United States v. Newman [16] and SEC v. Materia, [17] however, have made it perfectly clear that fact patterns such as the one that gave rise to Chiarella's prosecution will support a successful

prosecution under Rule 10b-5. In those cases, investment bankers and financial printers, having been placed in positions of trust and confidence in connection with the roles they played on behalf of bidders in contests for control of publicly traded corporations, betrayed those trust relationships by trading for their own accounts on the information they acquired. Such trading occurred at the expense of the firms that had initiated the relevant control contests, thereby giving rise to a cause of action under Rule 10b-5.

Along the way, the Supreme Court, in *Dirks*, clarified insider trading law still further by formulating a rule to handle the tricky problem of tippee liability.[18] Raymond Dirks was a financial analyst who acquired confidential news from former officers and directors of Equity Funding, a large insurance firm. The news was that the assets of Equity Funding were vastly overstated as a result of an internal fraud of epic proportions. Dirks, after verifying these tips at great personal peril and expense, advised several of his clients to liquidate their holdings in Equity Funding. Some of them took his advice, thereby avoiding windfall losses when the fraud was exposed.

Confirming the old adage that no good deed goes unpunished, the commission pursued Dirks to the full extent of the law. In absolving Dirks of liability, the Supreme Court handed the SEC its second straight major defeat in insider trading litigation. In doing so, the Court developed what is essentially a three-part test for ascertaining tippee liability. First, for a tippee to be liable, the person from whom he has acquired his information (the tipper) must himself have breached a fiduciary duty of some kind.[19] Second, a tippee must inherit the fiduciary duty of his tipper, which occurs only if he "knew or should have known that the tipper has breached" a fiduciary duty in passing along the information.[20] Finally, for a tippee to be liable in trading on such information, the tipper must do so for personal benefit, such as "a pecuniary gain or reputational benefit that will translate into future earnings." [21]

While there are significant problems with the test devised by the Court,[22] the central fact remains that in *Dirks* the Court reaffirmed the basic principle that the SEC's theory of liability in insider trading will not sustain judicial scrutiny because it is "rooted in the idea that the antifraud provisions [of the securities laws] require equal information among all traders." [23]

The Court based its affirmation of *Chiarella* on economic principles that evinced a solid respect for property rights. Specifically, the Court recognized the value to capital markets of encouraging the activities of financial analysts such as Dirks and declined to permit the SEC to regulate such vital activities in the ways it was attempting.[24] As the Court pointed out,

Imposing a duty to disclose or abstain solely because a person receives material nonpublic information and knowingly trades on it could have an inhibiting influence on the role of market analysts, which the SEC itself has said is necessary to the preservation of a healthy market. . . . The analyst's judgment . . . is made available [in various ways] to clients of [a firm he analyzes]. 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.[25]

The Political Fallout from *Chiarella* and *Dirks*

There is one lesson to be drawn from the above analysis that transcends all others. The lesson is that contrary to the assertions often made by those in favor of changes in the law, the rules regarding insider trading have become more rather than less coherent over time.[26] As such, we can reject the public-interest hypothesis that the demand for new insider trading legislation stems from those who simply wish to make the law clearer. The constraints on insiders' trading activities that were promulgated by the Supreme Court in *Dirks* and *Chiarella* were about as concise, coherent, and economically rational as judge-made law can be.

Thus, we must look for another, more realistic explanation for the current legislative initiatives on the subject of insider trading. Although the rules generated by the Supreme Court had much to recommend them from the perspective of a neutral observer, they posed some severe problems for certain special-interest groups that stood to lose from them.

From the perspective of the SEC, the problem with the Court's decisions was that they severely diminished the commission's power over its most important constituency, the investment banking community, which was the main beneficiary of those decisions.[27] Though the SEC responded to pressure from this constituency by dramatically

increasing its enforcement activities, it lost control of its own agenda.

Congress was faced with an angered constituency of its own. Specifically, by enforcing property rights in information, the Supreme Court's decisions on insider trading had greatly facilitated the operation of the market for corporate control. This, in turn, put pressure on the management teams of large corporations by increasing the probability that they would have to contend with a hostile takeover. The incumbent managers wanted a set of rules that would deprive people of their incentives to engage in a costly search for poorly managed or otherwise undervalued firms. It is from this group that the current near-hysterical demand for alteration of the Supreme Court's jurisprudence on the subject of insider trading has erupted.

As mentioned above, the SEC long had taken the position that it was a violation of Rule 10b-5 to trade on the basis of material nonpublic information regardless of the means by which the trader obtained such information. It is tempting to infer from this that the SEC's policy on insider trading was driven by a well-intentioned, albeit misguided, view that there should be a completely level playing field among securities traders. But as Michael Dooley pointed out in his careful study of SEC enforcement activities against insiders, until the Court's decision in *Chiarella*, the SEC rarely prosecuted anyone for violating its rule against insider trading.[28]

What inferences can be drawn from the odd combination of (1) an incredibly broad conception of what constitutes illegal insider trading and (2) an almost complete dearth of enforcement activity? The most plausible one is that the SEC employed an expansive conception of the scope of insider liability in order to enhance its own power and agreed to forbear from regulating insider trading in exchange for support from political supplicants.[29]

The Court's decision in *Chiarella* was an exogenous shock to that political equilibrium.[30] For the first time at least one interested group, market professionals, had an incentive to replace their request for regulatory forbearance with a demand for a greatly enhanced enforcement effort. This was because the Supreme Court for the first time had made it clear that although true insiders would be barred from trading on the basis of information they acquired in the course of their official duties, those who acquired nonpublic information through the traditional financial investigations by investment bankers would not be subject to liability for violating the rules against insider trading. Investment bankers and other professional information processors began demanding a greater enforcement effort by the SEC, and they got it.[31]

However, the SEC's administrative control over these supplicants has diminished because they now have the law on their side. The SEC would prefer to return to the days when the very vagueness and incoherence of insider trading law were a significant source of power. Consistent with this explanation is the SEC's indefensible refusal, for a considerable period of time, to promulgate a definition of insider trading. To have done so would have provided clarity and thereby limited the commission's power. To the extent that the rule remained vague, there would be a demand for the SEC's services and for its regulatory forbearance.

The Current Legislative Proposal

Not surprisingly in light of this analysis, the definition that the SEC ultimately promulgated, after considerable foot dragging, is a model of vagueness and obfuscation. In fact, the SEC has taken the remarkable position that if a definition of insider trading is to be enacted, it must be not only broad enough to include all activities currently prohibited by case law but flexible enough to be applicable to a range of investment activities that the commission has yet to define.[32]

It was not until the summer of 1987, after enactment of a statutory definition of insider trading had become a virtual certainty, that the SEC proposed legislation that would define the crime of insider trading. Sens. Donald Riegle (D-Mich.) and Alfonse D'Amato (R-N.Y.) had to make a specific request that the SEC assist their Securities Subcommittee in developing a definition acceptable to all parties. Finally, however, on November 18, 1987, the SEC issued a press release containing a proposed statute that it finds acceptable and that it believes will also be acceptable to the Ad Hoc Legislative Committee on Insider Trading, chaired by Harvey L. Pitt.[33]

The SEC's proposed insider trading bill contains some subtle yet significant differences from the law articulated by the Supreme Court. These changes, if implemented, would not only broaden the scope of the law but make its applicability

more vague than it currently is.

For example, current case law makes it illegal to trade "on the basis of" material nonpublic information. By contrast, the SEC's proposed statute would make it illegal to trade "while in possession of" such information. Under current law, in other words, defendants can assert in their own defense that although they may have been in possession of inside information when they traded, their trades were made on the basis of factors other than this information. This subtle change in language would make life much easier for plaintiffs in insider trading cases, particularly when the defendant has made a career of studying the company in whose shares he was trading.

Not only would this change of language enhance the SEC's power, it also would be likely to make the securities markets less efficient.[34] The only people who are able to drive share prices to their correct levels are those in possession of material information about a firm's stock. By banning all such people from trading, regardless of the source of their motivation for trading, the SEC would deprive the market of its principal source of rationality.[35] Because the proposed statute seeks to establish a conclusive presumption that possession, rather than use, of inside information is illegal, it stands to do an enormous disservice to the capital markets.

In one sense, the SEC's proposed statute appears to make things easier on defendant-tippees. Under current law, a tippee is liable if, among other things, he "knows or should have known" that the information he received was wrongfully obtained by the tipper. Under the SEC's proposed statute, however, the plaintiff is liable only if he "knows or recklessly disregards" that the information was wrongfully obtained by the tipper. Under the existing judge-made law, it is easier for plaintiffs to establish the mental state necessary to obtain a conviction, scienter, because they need only meet an objective standard; that is, they must establish that a reasonable person in the same circumstances would have realized that the information had been wrongfully obtained. By contrast, under the SEC's proposal, it appears that a plaintiff must establish that the defendant in a case traded on nonpublic information after disregarding available signals that the information had been wrongfully obtained. This rule change would be a benefit to market analysts and other market professionals who acquire corporate information in the course of their work and might be barred from trading under present law.[36]

In addition, the SEC's proposed statute would overrule a significant aspect of the Supreme Court's opinion in the *Dirks* case, a provision dealing with tipper-tippee liability. In *Dirks*, the Court held that tippees who obtained nonpublic information from corporate fiduciaries would not be liable for trading on the basis of that information unless the tippers had obtained a "personal benefit" of some sort in exchange for releasing the information to them. The statute proposed by the SEC removes the personal benefit requirement and makes it illegal to communicate information that has been wrongfully obtained if trading is "reasonably foreseeable." In other words, a tipper would be liable for passing along information if trading was reasonably foreseeable, regardless of whether he received a personal benefit for giving out such information.

This departure from case law would also be likely to harm the operation of the capital markets. The personal benefit test, though crude, allowed the courts to distinguish those cases in which insider trading provided benefits to the capital markets, such as *Dirks* itself, from those in which the individual traders involved in the transactions were the only beneficiaries.

In *Dirks*, the Court found that regardless of whether Ronald Secrist, who was Raymond Dirks's tipper, foresaw that Dirks would trade on the information he passed along, because Secrist received no personal benefit from passing the information, Dirks was not liable. This holding benefited markets by providing analysts such as Dirks with incentives to ferret out all sorts of socially useful information, including the financial fraud that brought Equity Funding to its knees.

Under the SEC's approach, analysts would be deprived of such incentives. Similarly, under the Supreme Court's approach, when a tipper gives information to a tippee in order to benefit not himself but his firm or his shareholders (say, in the context of a takeover battle), he does not face insider trading liability; under the SEC's approach, he would.

The SEC's proposed statute would also overrule the famous case of *SEC v. Switzer*,[37] which caused the commission considerable embarrassment. Barry Switzer, a football coach, was a spectator at a University of Oklahoma track meet. At the event, Coach Switzer overheard a man whom he knew to be a director of a publicly held corporation discuss

with his wife the impending liquidation of one of the corporation's subsidiaries. When Switzer traded on the basis of this overheard conversation between the director and his wife, the SEC brought suit. The court found that because the director did not personally benefit from passing along this information, Switzer, as the tippee, could not be held liable. Coach Switzer might have found himself in jail if the SEC's proposed statute had been the law of the land when he conducted his trading activity. The SEC would have had the court inquire whether the director had breached a duty to the corporation and whether Switzer had recklessly disregarded that the information had been wrongfully obtained. If so, Switzer would have been found guilty.

The SEC's proposal also makes a major departure from the existing law in its description of the contractual relationships that constitute relationships of trust for the purpose of regulating stock trading. Most significantly, the SEC would make it illegal to trade on the basis of the "breach of any personal or other relationship of trust and confidence, or breach of any contractual or employment relationship." Thus, the proposed statute would codify the controversial misappropriation theory upon which the SEC based its prosecution of R. Foster Winans.

Winans, an employee of the Wall Street Journal, was one of the authors of a daily column for securities investors called "Heard on the Street." Despite the fact that the Wall Street Journal considered the contents of the column to be confidential, Winans entered into an agreement with brokers at the investment firm of Kidder, Peabody under which he gave them advance warning of the timing and contents. These brokers made large trading profits by purchasing and selling stock on the basis of this information in advance of its publication in Winans's column.

Winans was indicted for violating Section 10(b) of the Securities Exchange Act of 1934. The court of appeals ruled that Winans had fraudulently misappropriated information from the Wall Street Journal and that this misappropriation could support a conviction.[38] The Supreme Court recently allowed the court of appeals' holding to stand.[39] After *Chiarella* and *Dirks*, there is nothing surprising about a decision that a breach of fiduciary duty can give rise to prosecution for violation of the rules against insider trading. Supposedly, the wrinkle in Winans was that the actual trading did not involve the stocks of companies to which the defendants owed a fiduciary duty. But in *Chiarella* itself, the defendant did not purchase shares in firms with which he had a contractual or quasi-contractual relationship.

In other words, the misappropriation theory adds nothing of substance to the law of insider trading developed by the Supreme Court in *Chiarella* and *Dirks*. Rather, it represents a change in the law of insider trading because it affects the important procedural question of standing. The interesting question posed by the misappropriation theory is whether purchasers and sellers of stock who traded at the same time as Winans have standing to sue for violations of Rule 10b-5. The judge-made law indicates that the answer is no.[40] The reason is that under the Supreme Court's theory of the law of insider trading, liability flows from the breach of a fiduciary duty by the defendant/trader. An implication of this theory is that only those market participants to whom the defendant owed a fiduciary duty at the time of their trading have standing to bring suit.[41]

The SEC's proposed statute would alter this state of affairs by granting standing to sue "in any court of competent jurisdiction to any person who, contemporaneously with the purchase or sale of securities that forms the basis of such violation, has purchased (where such violation is based on a sale of securities) or sold (where such violation is based on a purchase of securities) securities of the same class." [42] Thus, the SEC's proposed statute would greatly expand the scope of defendant liability by providing standing to sue to a whole class of plaintiffs to whom no fiduciary duty was owed.

Aside from being devoid of any theoretical or practical justification, the SEC's exceedingly expansive concept of standing in insider trading cases would undermine the basic theory of insider trading liability that federal courts carefully derived from the Supreme Court's holdings in *Chiarella* and *Dirks*. [43] Moreover, the rule of standing proposed by the SEC would achieve bizarre results. First of all, the violation of any sort of express or implied intrafirm employment agreement would give rise to a federal cause of action under the Securities Exchange Act of 1934 as long as securities trading was somehow involved in the transaction. In addition, not only the SEC and the U.S. attorney but anybody who was involved in contemporaneous trading of the relevant securities would be empowered to bring suit, despite the fact that in most cases no fiduciary duty would be owed by the defendants to such contemporaneous purchasers and sellers.

The proposed statute also grants standing to "any person injured by a violation of this section in connection with such person's purchase or sale of securities." [44] In expanding standing to nonpurchasers in this way, the SEC overrules the 1975 Supreme Court decision in *Blue Chip Stamps v. Manor Drug Stores*, [45] which required plaintiffs in insider trading cases to be actual purchasers or sellers of stock. There is no public-interest justification for this bizarre constellation of legal rules, in which a host of unrelated parties with absolutely no stake in the matter would be empowered to bring suit, while the real party in interest--the employer--would be empowered to translate a violation of a minor provision in an intrafirm employment agreement into a federal cause of action. It is anybody's guess how courts would grapple with the question of how to determine damages in such cases.

The SEC's proposed statute contains three exemptions that are worth noting. First, brokerage firms that implement policies and procedures that are deemed to be "reasonable under the circumstances" in order to prevent decision makers from possessing material nonpublic information are exempted from liability. [46] Because the SEC would be the ultimate authority as to whether the firms involved have taken reasonable steps of the kind described, this section would create a strong demand among the brokerage community for its advice on how firms should be organized so as to escape liability.

Second, by hiring a market professional who is not aware of or influenced by material nonpublic information, an insider may exempt himself from liability. [47] Needless to say, this provision benefits market professionals, who are the SEC's natural constituency.

Finally, lest there be any lingering doubt about the commission's desire to use the legislative process to gather power unto itself, its proposal gives it the authority to exempt by rule or by order "any person, security or transaction, or any class thereof, from any or all of the provisions of this section." [48] In a nutshell, the SEC's proposed statute is exceedingly complex, remarkably broad, and a shameless attempt to consolidate authority. By making the mere possession of nonpublic information a crime in certain circumstances, the act would restrict the flow of corporate information that is vital to the efficient operation of the market.

The foregoing analysis suggests that the SEC stands to gain not only by promulgating overly broad legal rules but also by creating confusion among market participants. Overly broad rules create demand for the SEC's ability to engage in regulatory forbearance. [49] Similarly, confusion about the state of the law fosters demand for the SEC's administrative guidance. The insider trading law that the commission has proposed is consistent with these models of its behavior.

Thus far this essay has focused almost exclusively on the SEC's interest in the compromise proposal that it generated. There is one substantive area in which the SEC was unable to find common ground with the Senate Ad Hoc Committee's views: regulation of the market for corporate control under the guise of insider trading law.

The commission's compromise bill essentially codifies SEC Rule 14e-3. [50] The SEC proposes to make it a crime to trade while in possession of material nonpublic information relating to a tender offer after "any person has taken a substantial step or steps to commence, or has commenced, a tender offer" if the trader knows or recklessly disregards that the information has been acquired directly or indirectly from the offering person, the target, or their agents. [51] In addition to making trading on information about an impending tender offer illegal, the SEC would make it illegal for offerors, targets, or their agents to disclose such information.

The Senate Ad Hoc Committee's proposed bill, S. 1380, [52] would go even further than the SEC toward barring trading in takeover targets' stocks by those who enjoy an informational advantage. S. 1380 seeks to prevent

any person planning an acquisition or disposition of an issuer, a material block of the issuer's securities or its assets, or any person acting on behalf of such a person . . . for the purpose of influencing or encouraging the purchase or sale of the securities of such issuer, to communicate, directly or indirectly, material, nonpublic information concerning such plans to any other person who thereafter purchases or sells the affected securities. [53]

The Senate Ad Hoc Committee would thus go beyond the SEC's proposal by regulating communications pertaining to transactions other than tender offers. But the goal of both statutory approaches is clear: to retard the operation of the market for corporate control by impeding the ability of "corporate raiders" to use nonpublic information about target firms in their quests for control.

Arbitrageurs and other market professionals play an important and valuable role in the market for corporate control by amassing large blocks of shares in anticipation of a shift in corporate management following a tender offer.[54] Arbitrageurs, of course, ultimately stand to profit by selling the shares they have amassed to a tender offeror. But arbs do not capture all of the gains in such transactions. Shareholders of the firms that are the subjects of the tender offers in which arbs participate also stand to profit, by garnering large capital gains on sales of their shares to arbs.

And bidders gain as well, because arbitrageurs' purchases lower their acquisition costs in several ways. For one thing, arbitrageurs often have expertise at ferreting out share blocks that is of incalculable value to bidders. In addition, an arbitrageur's successful purchase of the stock sought by a bidder can sometimes help the bidder obtain favorable financing for his tender offer. Finally, arbitrageurs facilitate bidders' activities by enabling them to conceal their identities and intentions until the last possible moment.

The use of nonpublic information is critical to the takeover process. Bidders who must disclose their plans regarding purchases of target firms' stock will be deprived of the incentive to engage in the costly search necessary to uncover undervalued companies and inefficient management teams. As such, if bidders are deprived of the ability to keep their plans and information confidential, there will be fewer corporate control transactions, and capital markets will be less efficient than they would be otherwise.[55]

At present, the Williams Act, the 1968 statute that regulates tender offers, severely impedes the operation of the market for corporate control by forcing bidders to disclose their identity and plans upon launching a tender offer (or within 10 days of acquiring 5 percent of a firm's stock via purchases that do not constitute a tender offer).[56] When bidders can (legally or otherwise) finesse the requirements of the Williams Act by taking advantage of the services of arbitrageurs, shareholders (not to mention the economy as a whole) are better off.

The incumbent management teams of corporations whose shares are likely to be targeted for acquisition are the only group harmed by the activities of arbitrageurs. Such management teams stand to lose their jobs if their firms are taken over. Thus, if incumbent management teams can mold themselves into an effective political coalition, they are likely to seek legislation that restricts the activities of arbitrageurs despite the public benefits of those activities.[57]

The legislation promulgated by the SEC and Congress reflects, to varying degrees, the effectiveness of incumbent management as a political coalition. Predictably, the insiders have had more success in influencing Congress than they have had in influencing the SEC. This is because the takeover activity of such market professionals as arbitrageurs provides direct economic benefits to investment banks, which are the SEC's most loyal constituent group. Indeed, the benefits to incumbent management that are seemingly contained in the SEC's proposed statute may be illusory, in light of the fact that the SEC has sought to retain broad authority to exempt particular groups from the provisions of the act. By contrast, the perspective of incumbent management is well represented in Congress, because incumbent management teams are spread throughout the country, while investment banks are concentrated on the coasts. As such, in Congress investment banks would likely be at a distinct disadvantage vis-a-vis the incumbent management group. This disparity of political power would be felt most strongly in the Senate, of course, because representation there is strictly geographic; but it would be felt in the House as well.

The Incoherence of the Justifications for New Regulation

To summarize, perhaps the most striking thing about the compromise statute proposed by the SEC is its incoherence. That is not surprising, because the SEC lacks a coherent theory to explain why the activities it describes in the statute should be regulated. Most notably, the statute provides no clear explanation of who is harmed by insider trading. At one point, the statute invokes such concepts as "misappropriation" and "conversion." The clear implication of this language is that insider trading should be proscribed because it involves the theft of a property interest (information) that rightfully belongs to someone other than the trader. But the fact that all those who purchase and sell stock contemporaneously with the insider would be given standing to bring suit indicates that the statute seeks to do something more than simply protect the property interests of those rightfully in possession of nonpublic firm-specific information.[58] Similarly, the provisions in the statute that seek to punish traders in possession of material nonpublic information, regardless of whether their trades were consummated on the basis of such information, cannot be reconciled with a property rights approach to the problem of insider trading.[59]

Indeed, property rights justifications for the rules against insider trading are inherently suspect. To be convincing, such justifications must explain why control of insider trading cannot be left to the plethora of private enforcement mechanisms available to contracting parties. The statute proposed by the SEC offers no such rationale. Even more perplexing from a property rights perspective is the question of why those who enjoy a rightful ownership interest in nonpublic information are forbidden by the statute from alienating such information by selling it.[60] A statute that outlaws such contracts and does not permit the relevant parties to waive its provisions through a consensual agreement cannot be defended from a property rights perspective.

It is also impossible to defend the proposed statute on the grounds that it promotes some conception of "fairness" in the marketplace. The fairness justification embodies the thoroughly discredited concept that no trade should be consummated unless both traders enjoy "parity of information." [61] Although this justification for insider trading regulation was long embraced by the SEC, the commission specifically rejected it when it proposed its compromise regulation.[62]

Having rejected both the fairness and the property rights theories as justifications for the law, we are left with the argument that the law is needed to protect the "integrity" of the nation's capital markets.[63] This is a hard argument to refute because nobody has ever bothered to explain what is meant by capital-market "integrity." Nor has anybody ever explained why we should restrict the efficient allocation of property rights in information in order to achieve such an ephemeral goal.

One version of the market integrity argument (often proffered by the SEC when it lacks a coherent justification for its actions) is that insider trading rules are needed because investors will lose confidence in the capital market unless they think that they are playing on a level playing field. There are at least four distinct reasons that this incarnation of the market integrity argument cannot be sustained.

First, the insider trading rules proffered by the SEC do not even attempt to achieve a level playing field. Most obviously, tender offerors who have an unambiguous informational advantage over their trading partners are left free to purchase shares on the basis of that advantage within the limits set by the Williams Act.

But perhaps more important, when insiders are barred from trading, no level playing field is created, because market professionals, often called quasi-insiders, still have an advantage over all other traders. Market professionals "devote their careers to acquiring information and honing evaluative skills" about a firm, an industry, or a group of firms or industries and to evaluating the information they obtain.[64] Even after true insiders were barred from trading under the SEC's proposed statute, market professionals, who owe no legal or fiduciary duty to refrain from trading on the basis of their lawfully acquired informational advantage, would be permitted, indeed encouraged, to trade. It is this group, rather than the trading public, that benefits from a general proscription on insider trading.

To put it another way, the level playing field manifestation of the market integrity argument rests on the bizarre premise that if insiders are barred from trading, the gains will be spread randomly throughout the economy. This is absurd. The competition to capture profits on the basis of information that is not reflected in a firm's share price at the time is a race that is won by the swiftest. The swiftest invariably turn out to be the cadre of market professionals, who have devoted their careers to acquiring, decoding, and acting upon the corporate information upon which trading profits are based. If insider trading is banned, the playing field does not become level; it simply tilts in a different direction.

The second reason that the market integrity argument cannot be sustained is that traders do not believe that the market represents a level playing field anyway. Traders can be divided into two groups. One group consists of investors who do not harbor the illusion that they can garner returns on their investments that are greater than those earned through a market index. Such investors will own a diversified portfolio of securities and adopt a buy-and-hold strategy. They will be immune from the effects of insider trading of any sort because they will be purchasing shares when insiders are purchasing just as often as they are purchasing shares when insiders are selling. As a consequence, such investors will not care whether insider trading is taking place.[65] By contrast, some investors--the market professionals--can garner profits through strategic (that is, nondiversified) trading. These investors want insiders to be banned not to make the playing field level but to make it irregular by stacking the deck in their own favor.[66] Of course, some traders who

are not market professionals believe that they could beat the market (that is, beat the market professionals) if insiders were barred from trading. The efficient capital market theory has shown this investment strategy to be extremely dubious. But in any case, such investors do not want a level playing field any more than the market professionals do. Rather, they want insiders to be removed from the competition so that they will have a greater advantage over those they believe to be less informed.

Third, as Ken Scott of Stanford Law School has observed, as long as the possibility of insider trading is known to all traders, outsiders cannot be disadvantaged, because the price they pay for their shares will be reduced by the amount necessary to compensate them for any excess risk they assume in purchasing the shares.[67] This is, as Dennis Carlton and Dan Fischel have pointed out, virtually "a complete response to the claim that investors are exploited by insider trading." [68]

But the best answer to the market integrity argument is that the securities markets of several countries in which capital formation techniques have reached very high levels of sophistication and in which secondary trading markets provide investors with great liquidity are not being subjected to bans on or regulation of insider trading at all.[69] Of particular interest in this regard are the complete lack of enforcement of the laws that are on the books in Japan and the absence of laws affecting the Hong Kong Stock Exchange.

The Tokyo Stock Exchange is roughly the same size as the New York Stock Exchange. Trading there is highly automated, and investors enjoy unparalleled liquidity for their shares. In recent years corporate stock traded on the Tokyo exchange has traded at a far higher price-to-earnings ratio than corporate stock traded on the New York Stock Exchange. In other words, there is absolutely no evidence of a crisis of confidence in the Japanese capital markets, despite the fact that "the Japanese stock market is an insider's paradise. There is no clear rule of law prohibiting insider trading and no public record of efforts to prevent the practice." [70]

Similarly, the regulation promulgated in 1974 to control insider trading in Hong Kong was repealed without any discernible effects on that robust marketplace.[71] Indeed, the recent trend toward insider trading regulation in Common Market countries appears to be largely due to pressure from the United States.[72]

Conclusion

In summary, the SEC's regulation of insider trading cannot be justified on the grounds that it promotes the goal of efficiency, fairness, or market integrity. This exhausts the public-interest rationales for the proffered regulation. Instead, the regulation we have been offered reflects a hodgepodge of special-interest concerns. It is thus no surprise that the proposed statute appears needlessly complex and lacks a coherent theoretical framework.

The best explanation for the statute is that it reflects the unrelated concerns of three powerful special-interest groups. The SEC itself is interested in keeping the law as vague as possible in order to maximize the demand for its services as an administrative agency. The recent enthusiasm in Congress for increasing the budget of the SEC in an era of fiscal belt tightening reflects the commission's success in this regard. Most of the publicity and the concomitant increases in congressional support for the SEC's activities are due to the commission's investigations of insider trading.[73]

In addition to the SEC, investment bankers and related market professionals, who stand to gain if true insiders are barred from trading, are a major source of demand for the proposed statute. Securities professionals and their lawyers have spent millions of dollars lobbying for a statute dealing with insider trading. It is impossible to imagine that they would provide this sort of support for a statute that was not in their interests.

The final group that stands to gain from the proposed statute is the incumbent management teams of companies that are subject to hostile takeovers. By supplementing the provisions of the Williams Act and related rules, the SEC's proposed statute would further impede the operation of arbitrageurs, who facilitate corporate control contests.

The point of this essay is not to suggest that it is impossible to come up with a coherent set of rules to regulate insiders' trading activities. In fact, the Supreme Court was moving quite decidedly in this direction in its enormously valuable decisions in *Chiarella* and *Dirks*. Though the law promulgated in these cases is by no means perfect, in every respect in which the SEC's proposed statute differs from that law, the statute represents an inferior product from the perspective

of the American public. As usual, the special interests have triumphed in the legislative process.

FOOTNOTES

[1] See David Haddock and Jonathan Macey, "Controlling Insider Trading in Europe and America: The Economics of the Politics," in *Law and Economics and the Economics of Legal Regulation*, ed. J. M. Graf von der Schulenburg and G. Skogh (Dordrecht, the Netherlands: Martinus Nijhoff, 1986), p. 149; and David Haddock and Jonathan Macey, "Regulation on Demand: A Private Interest Model, with an Application to Insider Trading," *Journal of Law and Economics* 30 (1987): 311.

[2] The following hearings were among those held recently:

(1) Insider Trading: Hearings before the House Subcommittee on Telecommunications, Consumer Protection, and Finance of the House Committee on Energy and Commerce, 99th Cong., 2d sess., June 18 and July 23, 1986.

(2) Oversight of the Securities and Exchange Commission and the Securities Industry: Hearings before the Senate Subcommittee on Securities of the Senate Committee on Banking, Housing, and Urban Affairs, 100th Cong., 1st sess., February 24, 1987.

(3) Improper Activities in the Securities Industry: Hearings before the Senate Committee on Banking, Housing, and Urban Affairs, 100th Cong., 1st sess., April 22, 1987.

(4) Definition of Insider Trading (Part I): Hearings before the Senate Subcommittee on Securities of the Senate Committee on Banking, Housing, and Urban Affairs, 100th Cong., 1st sess., June 17 and 19, 1987.

(5) Definition of Insider Trading (Part II): Hearings before the Senate Subcommittee on Securities of the Senate Committee on Banking, Housing, and Urban Affairs, 100th Cong., 1st sess., August 7, 1987.

[3] The following bills were among those introduced during the 100th Congress, 1st session:

(1) S. 230, introduced by Sen. Alfonse D'Amato (R-N.Y.) on January 6, 1987, would, among other things, provide a definition of insider trading and hold companies liable for civil monetary damages if they knew or should have known that their employees were engaging in illegal insider trading. For comment, see *Securities Regulation and Law Report (SRLR)*, January 16, 1987, p. 86; and *SRLR*, January 30, 1987, p. 171.

(2) S. 231, also introduced by Senator D'Amato, is an alternative to S. 230 that takes a broader approach to the insider trading problem. See *SRLR*, January 16, 1987, pp. 86-87.

(3) S. 657, introduced by Sen. Howard Metzenbaum (D-Ohio) on March 6, 1987, would mandate treble damages for insider trading and substantially increase the civil penalties for such trading, to a maximum of \$500,000, 5 years in prison, or both. See *SRLR*, March 6, 1987, p. 330.

(4) H.R. 251, reintroduced by Rep. Neal Smith (D-Iowa) on January 6, 1987, would amend the Commodity Exchange Act to bar insider trading in the futures industry and would also define "insider." See *SRLR*, January 23, 1987, p. 139.

(5) H.R. 1238, introduced by the chairman of the House Judiciary Criminal Justice Subcommittee, Rep. John Conyers (D-Mich.), on February 25, 1987, would mandate a 10-year jail sentence for criminal insider trading. See *SRLR*, July 24, 1987, pp. 1091-92.

(6) H.R. 2494, introduced by Rep. Richard Boucher (D-Va.) on May 21, 1987, would allow the SEC to pay rewards for information leading to the detection and prosecution of unlawful insider trading and market manipulation. See *SRLR*, May 29, 1987, p. 702.

(7) S. 1323, introduced by Sen. William Proxmire (D-Wis.) and cosponsored by Sen. Donald W. Riegle, Jr. (D-Mich.), among others, on June 4, 1987, concerns tender-offer reform. The bill would increase the maximum prison sentence for

insider trading from 5 years to 10 years and the maximum fine from \$100,000 to \$1 million. It would also require a minimum sentence of 1 year for perjury or obstruction of justice in connection with an insider trading investigation. See Definition of Insider Trading (Part I), p. 2.

The following special-interest groups have also been active in this area of reform: (1) the Securities Industry Association and its ad hoc group of industry officials exploring insider trading issues. See SRLR, January 23, 1987, p. 132; and SRLR, March 27, 1987, pp. 438-39. (2) the American Bar Association. (3) the North American Securities Administrators Association. See SRLR, April 17, 1987, pp. 544, 555. (4) the Securities and Exchange Commission (SEC).

See also Definition of Insider Trading (Part I), pp. 109- 41.

[4] Jonathan Macey, "From Fairness to Contract: The New Direction of the Rules against Insider Trading," Hofstra Law Review 13 (1984): 9.

[5] *Chiarella v. United States*, 445 U.S. 222 (1980).

[6] *Dirks v. Securities and Exchange Commission*, 463 U.S. 646 (1983).

[7] SEC, Proposed Insider Trading Bill, November 18, 1987.

[8] *Ibid.*, sec. 2(a)(1).

[9] See Macey.

[10] *Ibid.*, pp. 12-13.

[11] 445 U.S. at 235.

[12] *SEC v. Texas Gulf Sulphur*, 401 F.2d 833 (2d Cir. 1968) (en banc); cert. denied, 394 U.S. 976 (1969).

[13] 445 U.S. at 232-33 (finding that Chiarella owed no duty to disclose information to his trading partners or refrain from trading with them because he "dealt with the sellers only through impersonal market transactions").

[14] *Ibid.* at 233. Rule 10b-5 is contained in 17 C.F.R. sec. 240.10b-5.

[15] *Ibid.*

[16] *United States v. Newman*, 664 F.2d 12 (2d Cir. 1981); cert. denied, 104 S.Ct. 193 (1983).

[17] *SEC v. Materia*, 745 F.2d 197 (2d Cir. 1984).

[18] 463 U.S. at 646. A "tippee" is someone who acquires material nonpublic information from someone who enjoys a fiduciary relationship with the firm to which such information pertains.

[19] *Ibid.* at 663.

[20] *Ibid.*

[21] *Ibid.*

[22] Macey, pp. 37-39.

[23] *Ibid.*

[24] 463 U.S. at 658-59.

[25] *Ibid.*

[26] Further support for this point is that when Congress promulgated the Insider Trading Sanctions Act of 1984, Pub. L. 98-376, 98 Stat. 1264, codified at 15 U.S.C. secs. 78(c), (o), (t), (u), and (ff), which increased the penalties for violations of the prohibitions against insider trading to permit treble damage recoveries, it declined to include a definition of insider trading on the theory that the existing substantive law was adequate.

In 1983, Senator D'Amato proposed a draft bill containing a definition of insider trading, but officials at the SEC, including John Shad (then chairman of the SEC), Daniel J. Goesler (general counsel to the SEC), and John Fedders (then director of the SEC's Enforcement Division), testified against it. See *Insider Trading Sanctions Act of 1983: Hearings on H.R. 559 before the Senate Subcommittee on Securities of the Senate Committee on Banking, Housing, and Urban Affairs, 98th Cong., 2d sess., 1984, PP. 33-39.*

[27] See Haddock and Macey, "Regulation on Demand."

[28] Michael Dooley, "Enforcement of Insider Trading Restrictions," *Virginia Law Review* 66 (1980): 1.

[29] For an excellent theoretical explanation of how regulators can extract political support by forbearing to regulate, see Fred McChesney, "Rent Extraction and Rent Creation in the Economic Theory of Regulation," *Journal of Legal Studies* 16 (1987): 101.

[30] See Haddock and Macey, "Regulation on Demand."

[31] *Ibid.*

[32] Memorandum of the SEC in Support of the Insider Trading Sanctions Act of 1982, H.R. Doc. 355, 98th Cong., 2d sess., 1984, p. 25, reprinted in *United States Code Congressional and Administrative News, 1984, pp. 2274, 2298.*

[33] Letter from David S. Ruder, chairman, SEC, to Donald W. Riegle, chairman, and Alfonse M. D'Amato, ranking minority member, Senate Subcommittee on Securities of the Senate Committee on Banking, Housing, and Urban Affairs, November 18, 1987.

[34] In economists' standard conception of the term, the "efficiency" of a capital market depends on how quickly share prices in that market reflect information about the underlying firms. The more quickly share prices come to reflect such information, the more efficient the market is thought to be. Efficient markets serve as better indicators of a society's capital resources and hence are socially desirable.

[35] William J. Carney, "Signalling and Causation in Insider Trading," *Catholic University Law Review* 36 (1987): 863, 877- 86; Myron Scholes, "The Market for Securities: Substitution versus Price Pressure and the Effects of Information on Share Prices," *Journal of Business* 45 (1972): 179 (explaining that stock price movements are driven by traders who possess new information about the underlying securities, not by buying and selling volume).

[36] For a theory of why the SEC might adjust insider trading law to benefit market professionals, see Haddock and Macey, "Regulation on Demand."

[37] *SEC v. Switzer*, 590 F. Supp. 756 (WD Okla. 1984).

[38] *United States v. Carpenter*, 791 F.2d 1024 (2d Cir. 1986).

[39] *Carpenter v. United States*, no. 86-422, slip op. (November 16, 1987).

[40] *Moss v. Morgan Stanley, Inc.*, 719 F.2d 5 (2d Cir. 1983); cert. denied, 104 S.Ct. 1290 (1984) (holding that only those traders to whom the defendants owed a fiduciary duty had standing to sue for violations of Rule 10b-5).

[41] *Ibid.* See also Macey, pp. 48-53, where standing under current insider trading law is discussed.

[42] SEC, Proposed Insider Trading Bill, sec. 2(g)(1)(A).

[43] See Macey.

[44] SEC, Proposed Insider Trading Bill, sec. 2(g)(1)(B).

[45] 421 U.S. 723 (1975).

[46] SEC, Proposed Insider Trading Bill, sec. 2(b)(2)(B).

[47] *Ibid.*, sec. 2(b)(2)(A).

[48] *Ibid.*, sec. 2(f)(1).

[49] Peter Aranson, Ernest Gellhorn, and Glen Robinson, "A Theory of Legislative Delegation," *Cornell Law Review* 68 (1982): 1.

[50] 17 C.F.R. sec. 240.14e-3 (1982).

[51] SEC, Proposed Insider Trading Bill, sec. 2(d)(1).

[52] S. 1380, 100th Cong., 1st sess. (1987).

[53] *Ibid.*

[54] Michael C. Jensen, "Don't Freeze the Arbs Out," *Wall Street Journal*, December 6, 1986, p. 26.

[55] For fuller articulations of the economic underpinnings of this analysis, see Jonathan Macey and Jeffrey Netter, "Regulation 13D and the Regulatory Process," *Washington University Law Quarterly* 65 (1987, forthcoming); and Daniel Fischel, "Efficient Capital Market Theory, the Market for Corporate Control, and the Regulation of Cash Tender Offers," *Texas Law Review* 57 (1978): 1.

[56] Act of July 29, 1968, Pub. L. 90-439, 82 Stat. 454, codified as amended at 15 U.S.C. secs. 78m(d)-(e) and 78n(d)-(f) (1982). See Fischel.

[57] Haddock and Macey, "Regulation on Demand."

[58] On the other hand, the statute's treatment of trading in anticipation of tender offers by those who enjoy an informational advantage appears to be more or less consistent with a property rights or efficiency explanation of the legislation. As has been demonstrated elsewhere, a property rights analysis would allocate the rights to information about an impending takeover to the firm or individual that initiates the transaction. (See Macey.) This is usually the tender offeror. Consistent with this reality, sec. 2(d)(1) of the SEC's proposed insider trading law permits offerors to empower, through contractual arrangement or otherwise, other entities to purchase stock on their behalf. But, as discussed above, the rights afforded by one law may be restricted by another. The Williams Act places severe restrictions on the ability of offerors to amass purchasing groups that could acquire stock on their behalf.

[59] SEC, Proposed Insider Trading Bill, sec. 2(b)(1).

[60] Dennis Carlton and Daniel Fischel, "The Regulation of Insider Trading," *Stanford Law Review* 35 (1983): 861-72; David Haddock and Jonathan Macey, "A Coasian Model of Insider Trading," *Northwestern Law Review* 80 (1986): 1449-72.

[61] See Macey.

[62] Letter from David S. Ruder, p. 4: "The legislative history should state that the bill is intended to reaffirm the existing law concerning 'market' information and 'corporate' information, and regarding what constitutes 'material

nonpublic information,' including the Supreme Court's disavowal in *Chiarella v. United States* . . . that a 'parity of information' theory is intended."

[63] SEC, Proposed Insider Trading Bill, sec. 2(a)(1).

[64] Ronald Gilson and Reinier Kraakman, "The Mechanisms of Market Efficiency," *Virginia Law Review* 70 (1984): 549, 571; Haddock and Macey, "Regulation on Demand," p. 318.

[65] Because insider trading by managers lowers their demand for high fixed salaries from their firms, shareholders would prefer that insiders be permitted to engage in such trading. See Haddock and Macey, "A Coasian Model," p. 1449.

[66] See Haddock and Macey, "Regulation on Demand."

[67] Ken Scott, "Insider Trading, Rule 10b-5, Disclosure and Corporate Privacy," *Journal of Legal Studies* 9 (1980): 801.

[68] Carlton and Fischel, p. 881.

[69] See Haddock and Macey, "Controlling Insider Trading."

[70] Lawrence Repeta, "Declining Public Ownership of Japanese Industry: A Case of Regulatory Failure?" *Law in Japan* 17 (1984): 184. In Japan, "insider trading is considered proper, and there has never been a reported case under the limited insider trading prohibition currently in effect." Barry Rider and H. Leigh French, *The Regulation of Insider Trading* (Dobbs Ferry, N.Y.: Oceana Publications, 1979), cited in Carlton and Fischel, p. 860, n. 16.

[71] Carlton and Fischel, p. 860, n. 16.

[72] See Haddock and Macey, "Controlling Insider Trading."

[73] Of particular note, of course, is the publicity surrounding the recent prosecutions of Dennis Levine and Ivan Boesky.