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Richard W. Painter

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INSIDER TRADING AND THE STOCK MARKET THIRTY YEARS LATER

Richard W. Painter[†]

In 1966, Henry Manne argued that insider trading does not harm investors and can indeed be an efficient way of compensating insiders when they enhance an issuer's stock price.¹ If Manne's arguments were right, then the SEC's initiative to regulate insider trading under section 10(b) of the 1934 Securities Act, which had begun in earnest with proceedings against Cady, Roberts & Co. in 1961,² was wrong. The stakes were high, particularly for the SEC as it embarked on this new field of regulation, and the reaction to Manne's arguments from legal academics was overwhelmingly critical.³

Regardless of whether insider trading should in fact be prohibited, Manne did everyone—even proponents of insider trading regulation—a service by making his arguments so early in the debate over insider trading and by insisting that his arguments be answered not with platitudes, but with rigorous economic analysis of the financial markets. Over twenty years later, Jon Macey and David Haddock answered this call by identifying a convincing rationale for restrictions on insider trading: protecting property rights to information.⁴ Macey and Haddock, however, argued that property rights to investment information, like other property rights, are best protected by default rules rather than by immutable rules.⁵ Convincing economic

[†] Professor of Law, University of Illinois College of Law.

¹ See HENRY G. MANNE, *INSIDER TRADING AND THE STOCK MARKET* 138-41 (1966) (arguing that insider trading may be appropriate compensation for individual entrepreneurs to reward their contributions to building a successful corporation).

² *In re Cady, Roberts & Co.*, 40 S.E.C. 907 (1961).

³ See, e.g., Roy A. Schotland, *Unsafe at Any Price: A Reply to Manne, Insider Trading and the Stock Market*, 53 VA. L. REV. 1425 (1967) (challenging Manne's defense of insider trading).

⁴ See David D. Haddock & Jonathan R. Macey, *A Coasian Model of Insider Trading*, 80 NW. U. L. REV. 1449 (1986) (applying Coase's observation that, in the absence of transaction costs, contracting parties will reach an "efficient allocation of property rights" to the intrafirm relationship between shareholders and insider employees); see also JONATHAN R. MACEY, *INSIDER TRADING: ECONOMICS, POLITICS AND POLICY* 67 (1991) (arguing that "the only conceivable justification for banning insider trading is that such trading involves the theft of valuable corporate property from its rightful owner").

⁵ See MACEY, *supra* note 4, at 5 ("Because no uniform legal rule concerning insider trading would benefit all firms, individual firms should be able to allocate for themselves the rights to trade on the privileged inside information they legitimately possess. Firms should be able to make any allocation they desire, including one that gives such rights to corporate insiders."); see also Haddock & Macey, *supra* note 4, at 1449-50 ("[T]he nature of [the stock-

arguments thus still must be made to support the immutable rules that are enforced with increasing vigor now that the SEC's statutory mandate to regulate insider trading is clear.⁶

Jon Macey's essay in this Symposium makes a convincing case that some investors, particularly "price sensitive" investors, could bear the cost of allowing insiders to trade with an informational advantage.⁷ Macey also recognizes that insider trading opportunities could create perverse incentives for corporate managers which decrease shareholder wealth.⁸ Macey also points out, however, that insiders contribute to pricing efficiency and may provide other benefits to the securities markets.⁹ Ultimately, these costs and benefits of insider trading are likely to be reflected in an issuer's cost of capital. If so, it is arguably appropriate for the issuer to decide whether restrictions on insider trading should apply, and if so, how broad those restrictions should be. The default rule may thus still be preferable to the immutable rule.

In "classical" insider trading cases, where the issuer has an identifiable property right to most non-public investment information material to the issuer's securities, Macey's and Haddock's property rights to information theory articulates a legal and economic justification for insider trading regulation. In "misappropriation" theory cases, the connection between the legal property right to information and the economic justification for insider trading regulation, if any, is more tenuous. Still, at least in circumstances in which the third person owner of information is a participant in the securities markets (for example, a prospective tender offeror), that person most likely will bear the costs of insider trading on the information and should be allowed to decide how that information can be used.

As Macey points out, the courts have embraced both classical and misappropriation theories of insider trading that embody an approach based on property rights to information.¹⁰ This commentator

holder/insider] relationship acts as an incentive to both outside shareholders and insiders to allocate the right to trade on inside information to the group that values it most highly.").

⁶ See *United States v. O'Hagan*, 521 U.S. 642 (1997) (approving the SEC's misappropriation theory of insider trading). The parameters of the misappropriation theory approved of by the Court, however, are not so clear. See Richard W. Painter, Kimberly Krawiec, & Cynthia Williams, *Don't Ask, Just Tell: Insider Trading After United States v. O'Hagan*, 84 VA. L. REV. 153, 188-91 (1998) (pointing out ambiguities in the *O'Hagan* opinion, particularly with respect to the type of fiduciary relationship required to create a duty to disclose or refrain from trading).

⁷ See Jonathan R. Macey, *Securities Trading: A Contractual Perspective*, 50 CASE W. RES. L. REV. 269, 273-74 (1999) (discussing the effect on "price-function traders" of permitting insider trading).

⁸ See *id.* at 277-78 (arguing that insider trading may impede market efficiency by encouraging insiders to withhold information that would otherwise be made public so that they may first trade upon the non-public information).

⁹ See *id.* at 275-77.

¹⁰ See *id.* at 284-287 (noting the regulatory paradigm shift after *Chiarella v. United States*, 445 U.S. 222 (1980)).

is less impressed than Macey with Supreme Court jurisprudence in this area, and remains concerned that the misappropriation theory protects property rights in information that have little or nothing to do with securities markets or the purposes of the securities laws.¹¹ Nonetheless, Macey correctly identifies a property-rights based common theme in the Court's insider trading cases. In sum, Manne posed a question (why insider trading should be illegal, if at all) that has been answered at least in part by a property rights to information theory. The Court, with mixed results, has incorporated this property rights theory into its interpretation of the SEC's power to regulate insider trading under the 1934 Act.

I. COUNTING CARDS IN A CASINO

The analogy between a stock market and a casino is in some ways an apt one. Investors, like gamblers, take risks with their money by betting that certain events will or will not occur. Investors, like gamblers, weigh possible returns against the probability that these returns will occur and generally insist that the payoff from winning be great if the probability of winning is small. Investors, like gamblers, choose either relatively safe bets that pay a winner relatively little or more risky bets that pay a winner more. Investors, like gamblers, can diversify by spreading their bets around and betting on a range of events rather than a single event.

There are, however, important differences between a stock market and a casino. Virtually every casino expects to take something for "the house" each time a bet is made (the expected return for the gambler is negative and the expected return for the house is positive). In games that do not involve skill (e.g., the roulette wheel), a gambler inevitably will lose money if she plays long enough. In games that involve skill, gamblers as a whole will lose, although some may come out ahead. Casinos that give a positive expected return to their customers do not stay in business for very long.

The stock market of course is different; although brokers, market makers, and other intermediaries take their share of investors' profits, there is no "house" that skims so much from the market that the investor is likely to leave the market with less money than she started with. Indeed, most investors in the stock market make money over time, and diversified investors who do not incur the transaction costs of excessive trading, in the long run are almost certain to share in

¹¹ See Painter et al., *supra* note 6, at 190 (arguing that "a serious shortcoming of the misappropriation theory [is that] [i]nsider trading liability turns not on effects on the marketplace or on potential damage to selling or purchasing shareholders, but rather on a duty owed to the source of the information, regardless of whether that source is a buyer or seller of securities or even a market participant at all").

these gains. Unlike gambling at a card table or roulette wheel, gambling with investment capital has a positive expected return.

Card counters are not popular in casinos. If caught, card counters are usually ejected or required to play other games where their informational advantage cannot be used (perhaps craps or roulette). If successful, card counters can beat the house over time, and by increasing the size of their bets, they can substantially erode a casino's profits. The casino could, of course, tolerate a few card counters and make up for its losses by changing the payoffs in its own favor, but doing so might cause other gamblers to take their business elsewhere. The money that the card counter takes home must come from somewhere, and either the house, the other gamblers, or both will pay for his having a seat at the table.

The insider trader is in some ways like the card counter; she plays with an informational advantage that other investors do not have.¹² If she is allowed to play, the money she takes home because of her informational advantage must come from somewhere. This "somewhere" is most likely other investors in the stock market, although not necessarily the persons she trades with. Jon Macey, in his essay, correctly identifies the price-sensitive trader as the person most likely to bear the costs of the insider's informational advantages.¹³ To the extent specialists incur costs from trading with insiders, they are likely to pass at least some of the costs on to other investors—particularly investors who trade frequently—by increasing their bid-ask spreads.¹⁴ Because mutual funds and pension funds often are price-sensitive investors, and trade frequently, these costs are likely to be spread around among a great many investors rather than being born by a few.

Macey and Manne point out, however, that the insider trader brings value to the market in return for her profits. Unlike the card counter, whose bets are unlikely to systematically influence the bets of other gamblers, the insider trader makes market prices more accurately reflect all available information (strong market efficiency instead of the semi-strong efficiency that prevails in the absence of insider trading). Other investors are more likely to pay an "accurate" price for a security when insiders trade than when they do not. On the other hand, insiders who cause an issuer to delay public announcement of important news can decrease market efficiency. Furthermore, to the extent price sensitive investors fear losses to insiders and consequently switch to buy and hold strategies or index funds, price ac-

¹² The card counter, of course, uses only her own mental facilities (memory) to create the information whereas the insider trader uses externally created information.

¹³ See Macey, *supra* note 7, at 274.

¹⁴ See *id.* at 278.

curacy may suffer from the departure from the market of investors whose trades help make the market efficient.

Macey also takes up Manne's argument that insider traders may increase the total amount of money available for distribution among all investors. Total wealth will increase if insiders are encouraged by the possibility of insider trading profits to create value-enhancing projects that increase stock price.¹⁵ On the other hand, insider trading profits may bear relatively little resemblance to the value added to an issuer's stock price by the insider, and indeed insiders who trade on bad news may be getting compensated for their failures rather than their successes.

To this commentator, the verdict on whether the insider trader brings more value to the table than she takes away in profits is mixed. Some insider traders create more value than they take for themselves (for example, the scientist who might be inspired by insider trading profits to develop a new drug for a drug company), but many others take away profits that far exceed the value that they add. Although the cost of detecting insider trading and enforcing insider trading regulations must be taken into account, non-insiders would probably still prefer to invest in a market in which other investors did not trade on inside information.

This being said, the fact that the costs and benefits of insider trading may weigh differently in different situations is an argument in favor of allowing issuers to opt out of insider trading regulation. Alternatively, the locus of regulation could be the stock exchanges, and issuers could choose their regulatory regime by choosing the exchange on which their securities are listed. This author differs from Manne and believes that the majority of issuers would choose not to allow insider trading. In most circumstances, shareholders would not tolerate its costs and would not value its real or perceived benefits. However, a good argument can be made that issuers (with shareholder consent) or at least the stock exchanges ultimately should be the ones to decide, not external regulators.¹⁶

II. EJECTING THE CARD COUNTERS

Most casinos have formal or informal definitions of illicit card counting and methods for detecting and sanctioning violators. The

¹⁵ See Macey, *supra* note 7, at 279-282 (discussing the theory of insider trading as compensation for entrepreneurial efforts); see also MANNE, *supra* note 1, at 138-41 (arguing that insider trading may increase shareholder value because of the presence of additional incentives for insiders to increase the value of corporate shares).

¹⁶ The practical implications of such a regime are significant, however, and need to be addressed more extensively by proponents of default rules for insider trading. In other words, despite the theoretical appeal of an opt-out regime, the SEC's immutable rules could practically be the most efficient means of regulating insider trading.

SEC, with the support of the courts, has for almost forty years embarked on a similar effort to eject persons who trade on informational advantages from the securities markets. This commentator's most significant difference with Macey is one of degree in evaluating how effective and coherent case law has been in this area. In particular, this commentator remains concerned that Congress has yet to enact a statutory definition of illegal insider trading and that the SEC has declined to promulgate one by regulation.¹⁷ Reliance on common law has been misplaced as the Court's insider trading jurisprudence has evolved very slowly and with considerable inconsistency.¹⁸

This essay can only briefly summarize the observations made by this commentator and others elsewhere: that the misappropriation theory as articulated by the Court in *O'Hagan* is inconsistent with the Court's prior holdings, particularly in *United States v. Chiarella*¹⁹ and *Santa Fe Industries, Inc. v. Green*;²⁰ that it is difficult to determine when a fiduciary relationship exists giving rise to a duty not to trade on information entrusted in the course of that relationship; and that the misappropriation theory is incomplete in requiring only disclosure to the principal of the fiduciary's intent to trade rather than the principal's permission to trade (the "Don't Ask, Just Tell" component).²¹ Unanswered questions also remain to be resolved by the Court, such as whether "warehousing" (purchases of a security by persons tipped off about a prospective tender offer by a tender offeror who gives the tippees permission to trade) is within the reach of section 14(e) of the 1934 Act²² (warehousing clearly falls outside of the reach of section 10(b) as interpreted in *O'Hagan*). Finally, it remains to be seen whether the SEC is sincere in its intention to kick some of the worst "cheaters" out of Wall Street's casino: analysts who obtain selective disclosures in "closed door meetings" and conference calls with managers, who then pass this information to both their employers and customers.²³

¹⁷ At the time of this writing, the SEC is considering promulgating some definitions with respect to the misappropriation theory.

¹⁸ See generally, Painter et al., *supra* note 6 (discussing the Court's insider trading jurisprudence).

¹⁹ 445 U.S. 222 (1980) (requiring a duty to disclose and a breach of that duty for there to be a violation of section 10(b)).

²⁰ 430 U.S. 462 (1977) (holding that a mere breach of fiduciary duty cannot be a predicate for a violation of section 10(b)).

²¹ See Painter et al., *supra* note 6, at 178 (noting that the *O'Hagan* court found that "once a fiduciary duty and a breach of that duty are found, it is the failure to disclose the breach to the principal, not the breach itself, that creates liability under Section 10(b)").

²² This question is expressly reserved by the Court in a footnote in *O'Hagan*. See U.S. v. *O'Hagan*, 521 U.S. 642, 672 n.17 ("We leave for another day, when the issue requires decision, the legitimacy of Rule 14e-3(a) as applied to 'warehousing' . . .").

²³ At the time of this writing, the SEC has begun expanding enforcement efforts aimed at such abuses.

III. THE LEGACY OF HENRY MANNE

The legacy of Henry Manne in insider trading jurisprudence is that he dared to ask a question that needed to be asked (why insider trading should be illegal) and then provided an answer that, even if it was not entirely correct, needed to be debated. Jonathan Macey, David Haddock, and some other scholars have taken Manne's arguments seriously, subjected insider trading to rigorous economic analysis, and answered Manne on his own terms.

Unfortunately, the SEC and Congress have for the most part bypassed this discussion. Although the courts have slowly crafted a body of case law that embodies some principles that ought to underlie insider trading regulation—principally protection of property rights to information—this case law has yet to articulate a clear definition of illegal insider trading.²⁴ If the discussion that Manne inspired took place in Washington as well as in the academy, Congress and the SEC probably would not have decided to legalize insider trading, but the law would embody some degree of consensus about what type of insider trading is harmful to investors, and why. This consensus would in turn have provided a clear justification for insider trading regulation in the legislative history and perhaps most important, a definition in statute or regulation of what type of insider trading, tipping, trading on misappropriated information, and related conduct is proscribed.

Over thirty years ago, Henry Manne refused to accept the answer that insider trading should be illegal "because it is simply wrong" or "because it is unfair." Such answers are still inadequate, and without better answers, insider trading jurisprudence will continue to suffer not only from lack of clearly defined rules, but also from a perceived lack of economic purpose.

²⁴ See Painter et al., *supra* note 6, at 211-28.

