Comment from an Enforcement Perspective

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I completely endorse Professor Macey's acknowledgment of Henry Manne's contribution to the insider trading debate. While Macey's paper concentrates on the substantive law of insider trading, this essay focuses on the enforcement aspect of insider trading and particularly the relationship of the enforcement process to the underlying substantive goals of the law being enforced. Once again, Manne gets the credit for being the first to recognize the importance of the enforcement issue. In what is almost a throw-away line in his *Insider Trading and the Law Professors* article, Manne recognized that "a number of aspects of the insider trading debate turn on the efficiency with which a rule against such trading can be enforced."¹

In my mind, the history of insider trading during the last nearly forty years is a classic case study in how the enforcement process can come to dominate a legal rule with poorly defined substantive goals. My designation of a forty-year history is important because I disagree with the timeline suggested by Professor Macey's paper. There is absolutely no evidence in the legislative history of section 10(b) or accounts of the SEC's adoption of Rule 10b-5 eight years later that either Congress or the Commission was even thinking about insider trading as a target of the statute or the rule.² Moreover, it is quite impossible to read "insider trading" or "disclose-or-abstain" into the language of either the statute or the rule. Even section 16(b), which appears facially to be relevant, is not concerned with "insider trading" in the modern sense. Rather, it is concerned with short-term trading by designated insiders and reflects Congress' overwhelming concern in 1934 with "manipulation" and "speculation," not the use of private information.³

¹ William S. Potter Professor of Law, University of Virginia School of Law.
² See Michael P. Dooley, Enforcement of Insider Trading Restrictions, 68 VA. L. REV. 1, 56-59 (1980) (noting that the hearings preceding the 1934 Securities Exchange Act focused on insiders' participation in pools intended to manipulate the stock of their corporations, not on insiders' exploitation of an informational advantage).
³ See id. at 57-58.
Insider trading was not created by statute. It is, instead, a creature of the common law that has been developed at the behest of a governmental agency seeking to justify an expansion of its jurisdiction beyond the limits initially set by Congress in the Securities Exchange Act of 1934. Although this may be attributing too much insight, it is arguable that the Commission was aware that it was straining, if not straying beyond, its legislative boundaries in In re Cady, Roberts & Co., in which the Commission “discovered” that it had been given authority to regulate insider trading twenty-seven years earlier. Chairman Cary explained that the duty to refrain from trading on inside information,

rests on two principal elements; first, the existence of a relationship giving access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone, and second, the inherent unfairness involved where a party takes advantage of such information knowing it is unavailable to those with whom he is dealing.\(^5\)

The explanation is incoherent: it is unlawful to take property from A because it would be unfair to B. But what is B’s claim to A’s property, and what does the second part of this test have to do with the first? Why isn’t the *actus reus* completed by the wrongful taking of another’s property? The answers to these questions are easy: the second part of this test has nothing to do with the first part, the wrongful act is the unauthorized use of the corporation’s property, but the Commission needed to posit some injury to investors in order to justify its assertion of jurisdiction.

Dean Manne was the first to pick up on this weakness in the investor-welfare arguments in favor of prohibiting insider trading, and I still believe he has the better of the argument. Notwithstanding the possible effects on spreads or price-sensitive traders\(^6\) pointed out in Professor Macey’s paper, insider trading has never had much to do

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\(^5\) *Id.* at 912 (citation omitted).

\(^6\) The argument that price-sensitive traders may be misled by unexplained changes in an issuer’s share price and induced to trade the wrong way is not entirely convincing. The most “price sensitive” traders are likely to be market professionals who are certainly aware of the possibility of insider trading and who are thus likely to take insider trading into account as a possible cause of otherwise unexplained increases or decreases in share price. This is certainly true of the most fertile source of insider trading opportunities: pre-announcement leaks of a proposed merger or takeover. The next largest category of price sensitive traders are day-traders who, by definition, are unconcerned with changes in long-term fundamentals and close out their positions on a daily basis.
with investor welfare.\textsuperscript{7} Once one assumes satisfaction of the first part of the \textit{In re Cady, Roberts & Co.} test, that is, that there is a corporate purpose for keeping the information in question secret, it becomes apparent that there is no causal connection between the "losses" claimed by outsiders and the insider's trading.\textsuperscript{8} Insiders are incidental participants in a zero-sum game between outsiders that would go on without them.

Unfortunately, the continuing debate over whether outside investors are harmed or benefited by insider trading has tended to crowd out more mature consideration of whether there are other, legitimate reasons for regulating insider trading. I think there are and, once again, Manne was the first to point to one of them. Manne's principal argument was that insider trading was primarily a matter of contract between the corporation and its officers and directors. The parties might or might not agree to the use of confidential information as a form of compensation. But to see the case for insider trading regulation, we need to take one additional step backward to consider the foundation of contract: property rights. The failure to realize that insider trading is really concerned with property rights has led to a second failure. The lack of a property rights analysis fails to appreciate that what we regard as the single offense of "insider trading" actually involves two distinctly different acts, involving two distinctly different sorts of actors, and implicating two distinctly different regulatory responses. The exemplars of these types are \textit{Texas Gulf Sulphur}\textsuperscript{9} on the one hand, and \textit{Chiarella}\textsuperscript{10} on the other. \textit{Texas Gulf Sulphur} is a compensation case. \textit{Chiarella} is a simple case of theft.

To see how things might have played out from a property rights perspective, we need to assume different behavior by the agency charged with administering the law. So imagine a world in which administrative agencies do not constantly seek to expand their jurisdiction and instead adhere faithfully to their legislative grant of authority, returning to the legislature to make a principled case for the expansion of their jurisdiction.

How might such an agency have responded to the \textit{Texas Gulf Sulphur} episode? The agency might have sought new authority, but it is more likely that it would have relied on its existing authority under


\textsuperscript{8} \textit{See} Fridrich v. Bradford, 542 F.2d 307, 318 (6th Cir. 1976) (finding that "[i]nvestors must be prepared to accept the risk of trading in an open market without complete or always accurate information. Defendants' trading did not alter plaintiffs' expectations when they sold their stock, and in no way influenced plaintiffs' trading decision").

\textsuperscript{9} SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968).

\textsuperscript{10} \textit{Chiarella} v. United States, 445 U.S. 222 (1980).
the proxy rules. Taking its cue from state corporation law, the agency would have realized that the common law has always adopted a hands-off approach with regard to the amount of explicit compensation paid to corporate executives. However, the agency has also taken a strict stance against hidden forms of implicit compensation and required divestiture of corporate opportunities, disgorgement of profits made from unauthorized use of corporate property and the like. This arrangement of rules—lenient with regard to explicit compensation and strict with regard to secret compensation—is eminently sensible. Shareholders are the best judges of the value of their executives' contributions to the corporation and are entitled to know how much they are paid. Shareholders might well, as Manne argued, be indifferent to the forms of compensation, but they would certainly be interested in the total amount of compensation paid to executives in addition to their announced salaries and bonuses.

Since the SEC already had the authority to require disclosure of compensation, they had ample grounds on which to prosecute Texas Gulf Sulphur as a violation of the proxy rules. Subsequently, and without straining its authority, the agency might have amended the disclosure regulations under the proxy rules to require an \textit{ex ante} announcement by the corporation as to whether insiders would be permitted to trade on inside information together with some sort of \textit{ex post} settling up by the insiders themselves. As far as penalties are concerned, the monetary remedy most often sought by the SEC in its early days, disgorgement of profits, seems about right. Given that bona fide insiders are an easily identified group, the costs of detection are quite low, the probability of apprehension and punishment are quite high, and a relatively low nominal sanction seems appropriate. This way of proceeding, while well within the boundaries of established law, would not have generated the headlines that the agency sought in its well-publicized quest to "conquer" insider trading.

From \textit{Chiarella} on, it became apparent that the enforcement strategy followed in and from Texas Gulf Sulphur would no longer work. This was so because \textit{Chiarella} marked the emergence of a new type of insider trader, the information thief, later epitomized by Ivan Boesky. These actors generally had no known connection to the corporate issuer and appropriated its proprietary information through

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\item See MICHAEL P. DOOLEY, FUNDAMENTALS OF CORPORATION LAW 677 (1995) ("As a general rule, American courts have treated compensation as a matter of business judgement . . . . On the other hand . . . a large part of the Duty of Loyalty seems to be concerned with discouraging secret, 'implicit' forms of compensation.").
\item See Dooley, supra note 2, at 73 (discussing practical and theoretical problems of enforcement in the wake of \textit{Chiarella}).
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theft, bribery of employees, and other corrupt means. Unlike the potential compensatory value of insider trading for corporate executives, this use of information has no redeeming social value and imposes real costs on the corporate owner of the information. The fact that this new band of information thieves had no known connection to the issuer and frequently took elaborate precautions to cover its trail greatly complicated the SEC’s detective task and decreased the probability of actual punishment to such an extent that available sanctions afforded virtually no deterrence.\textsuperscript{14}

Was this a job for the SEC? Yes, not because the theft of corporate information harmed uninformed traders but because the invariable scene of the crime was the stock market, a venue where the SEC’s monitoring experience and ability to commandeer the resources of the exchanges and the NASD give it a comparative advantage in policing. From an enforcement perspective, an increase in the nominal sanction for insider trading seemed necessary if there was to be any deterrent effect on the information thief. The 1984 and ITS-FEA acts sharply increased the sanctions for insider trading, but did nothing to define and justify the \textit{de facto} expansion of the SEC’s jurisdiction and, most shamefully, did not even bother to define “insider trading.” As a result, the SEC now has at its disposal an array of fierce penalties, to be imposed at its discretion on whomever strikes its fancy.

I am not suggesting that the SEC discriminates in its selection of enforcement targets. I am suggesting that publicity and other considerations that appear likely to advance the agency’s interests often determine its choice of an enforcement target.\textsuperscript{15} One consequence of this has been continuing doubt over the permissible limits of analysts’ attempts to obtain useful information from issuers.

So, we are basically back where we started with an ill-defined law with hazily defined goals. Contrary to the \textit{Palsgrave Dictionary} entry and \textit{The Economist} article quoted in Professor Macey’s paper, the fault lies not in Henry Manne’s failure to convince legislators and regulators of his views.\textsuperscript{16} The fault lies in their failure to engage and debate seriously the basic issues that Manne courageously raised in 1966.

\textsuperscript{14} See Dooley, supra note 11, at 840-44 (describing the complex investigation that eventually led to the conviction of Ivan Boesky and arguing that, because the SEC had already maximized the probability that an offender would be caught, additional deterrence was only available through increased sanctions).


\textsuperscript{16} See Macey, supra note 7, at 288.