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INSIDER TRADING--DETRIMENTAL OR BENEFICIAL?
The Lawyer v. The Economist

The views expressed herein are those of Commissioner Peters and do not necessarily represent those of the Commission, other Commissioners, or the staff.

Introduction--Defining the Issues

The area of insider trading has been one of special focus for the Commission. This is not to say that the SEC is neglecting other enforcement areas but insider trading is clearly and properly a priority item on the Commission's agenda. As I am sure you know, a number of the Commission's insider trading cases have received considerable publicity, if not notoriety, and the question has been asked, notably by several economists, is insider trading really a menace to our financial markets or is it actually beneficial?

The Commission is of the view that trading securities on material non-public information affecting the value of those securities, which is what the prohibition on insider trading is all about, is inherently unfair and is detrimental to the integrity of our securities markets. On the other hand, there is a relatively small, yet vocal group, made up primarily of economists, that argues that insider trading actually enhances the efficiency of our securities markets without harming "outsiders". One of the chief proponents of this view has been Henry Manne, an economist/lawyer who heads the Emory University Law and Economics Center. Mr. Manne believes so strongly that insider trading is beneficial that he has even gone so far as to characterize the Commission's efforts against insider trading as a "witch hunt". Understandably, the Commission has difficulty visualizing itself as a contemporary reincarnation of those wrathful Salem Puritans of 200 years ago. A recent headline announcing a similar view held by Dr. Mark Moran, an economist at the Case Western Reserve University,

made me want to inquire into the basis for their position and reflect on whether they were right. It will not surprise you to learn that I have concluded they are wrong.

This evening, I will explore the economists' theories and share with you my reasons as to why I believe they are misguided.

Now, during the course of my remarks, I may make a few irreverant remarks about economists and the worthiness of their methodology and theories. I hope that no one takes offense because certainly none is intended.

Many theories underlie the traditional attitude that insider trading should be prohibited. First and foremost is the idea that insider trading undermines investor confidence in the integrity of the marketplace. As a result, investors, particularly investors like yourselves, are driven from the market for fear of having potential trading gains appropriated by insiders who are privy to material non-public information. To the extent that investors are deterred from the market, the liquidity of the market and thus, capital formation, is impaired. In addition, the proscriptions against insider trading are based on the notion that insiders should not be allowed to capitalize on information they receive as a result of their privileged status at the expense of the ignorant shareholder/investor.

Economists respond, to the contrary, that investors are actually brought to the marketplace as a result of insider trading. Manne and his adherents assert that market efficiency is in fact

enhanced when insiders take advantage of their superior knowledge. Subsumed in this hypothesis is (1) the notion that insider trading is a victimless crime, and therefore, is not unfair, (2) that securities prices affected by insider trading more accurately reflect a company's worth, and (3) that critical news may actually reach the marketplace more quickly if insiders are permitted to take it there.

They also argue that any profits gained by corporate managers who trade on the basis of information which they receive in the course of their duties is merely an ancillary form of compensation for entrepreneurial efforts. Rather than viewing the use of inside information as the misappropriation of corporate business property, the economists stress that it is management's perogative to allocate property rights in information as they deem appropriate. I wonder whether the shareholders of General Motors and Ford Motor Co. would agree with this proposition if they had learned that in addition to being paid bonuses of $1,000,000, and $1,500,000, Messrs. Smith and Caldwell, the respective Chairmen of those companies, had been rewarded for their entreprenurial efforts with another half million dollars or so in insider trading profits. Ancillary compensation indeed!

In my view, economists who argue that insider trading is beneficial do so based on a model of the world that is totally at odds with reality. First, some of them misconceive, or ignore, the nature of the proscription itself and secondly, they posit benefits and rewards based on assumptions that are untenable and unrealistic.

Let's take a closer look now at these theories, starting first with the economists' view of the fairness issue.

Economists View of the Fairness Issue

Some economists scoff at the notion that insider trading is unfair and creates an imbalance in the market place. Indeed, those economists argue that sufficient market incentives exist to deter insider trading if, indeed, investor confidence is actually undermined by the practice. To illustrate their theory, economists create a hypothetical world in which no restrictions on insider trading exist. They then assume that all firms would permit their officers and directors to trade on material non-public information. They conclude that if the only effects of this practice are to enrich insiders and undermine investor confidence in the integrity of the market, a firm would have an economic incentive to distinguish itself from its competitors for the investors' dollar by adopting a publicly announced policy of proscribing insider trading by its officers and directors. The incentive for doing so would be to have the ability to raise capital at a lower cost than all other firms. But why would there be a difference in the cost of raising capital between the two types of firms? The economist answers with an analogy to gambling.

They argue that in order to induce someone to gamble with loaded dice vis-a-vis fair dice, an appropriate adjustment in the odds is necessary. Similarly, if investors view insider trading as akin to loaded dice, then publicly held companies that permit officers and directors to trade on material non-public

information will be required to compensate traders in their securities with a higher expected return in order to compensate them for the increased risk that their trading gains will be appropriated, at least in part, by insiders. Any firm that voluntarily prohibits insider trading would be able to issue securities at a lower cost, since investors in its securities would not have to be compensated for the risks of insider misappropriations of trading gains. But if one firm were to prohibit insider trading, then all other firms would be at a competitive disadvantage in raising capital. Ergo, in equilibrium, the economists argue that the discipline of the capital market would require all firms to prohibit insider trading. The economists conclude that since corporations don't prohibit insider trading in their charters or bylaws, these market forces are not in effect, and therefore, the concerns they generate are invalid.

Now, if you did not follow that line of reasoning, don't be concerned. I may have not understood the point well enough to absorb it in a manner permitting me to relay it accurately to you--that could be the problem or it could be that the theory is incomprehensible because it ignores what is true. First, the real world proves the economists wrong because, notwithstanding the fact that prohibitions against insider trading are not included in corporate charters or bylaws, that activity is proscribed by contract or edict. It is commonplace for companies to forbid trading by its employees on material inside information. Indeed, more often than not a corporate officer or director risks losing his job if he transgresses this rule. Thus, clearly the

issuers of securities have already determined they are at a competitive disadvantage if they are perceived to be lax about restricting insider trading. Economists are 50 years behind the times in their thinking when they argue to the contrary.

Furthermore, the misconduct we have labeled "insider trading" is not limited to traditional insiders, namely employees of the company whose stock is being traded. Companies cannot control, by either contract or fiat, non-employees who by some means or other obtain and trade upon inside information, thus affecting the integrity of the market and the issuers' stock. Many of the cases in this area that the Commission has pursued have been against non-traditional insiders such as journalists, taxi cab drivers, lawyers, and financial printers. The circumstances that gave rise to these cases are ignored by the economists' theory that insider trading, if detrimental, will be controlled by market pressures on issuers, who will in turn control their employees, and yet "insider trading" by others than traditional insiders is just as detrimental to the integrity of the market as such trading by corporate management.

Finally, the economists claim that insider trading is truly a victimless crime. They claim--in an impersonal market, an investor knows the price at which a security is trading and makes a voluntary judgment to trade regardless of the existence of insiders. It is merely fortuitous when the contra party to a trade is an insider. The argument goes on to say that the investor gets exactly what he bargained for--nothing more, nothing less.

I must say that is a rather narrow view of fair play, and fair play is all we're really talking about. The notion that the stock market's not rigged and that the rules of the game favor no one. The idea that we all play the market with equal access to information. These are the ideals that have historically fostered investor confidence in the integrity of the market. It is this confidence that has enabled our American markets to maintain their liquidity and depth. And it is this confidence that has made our American markets a place for institutional and individual investors alike. Admittedly, professional investors and institutions are more knowledgeable or at least better informed than you or I, but the point is that equivalent information is available to the average person through public filings, broker/dealers and investment advisers--professionals who earn their living by insuring that you make more <u>right</u> investment decisions than <u>wrong</u> ones. Thus, theoretically, no one has an informational advantage.

Moreover, beyond the question of fundamental fairness, it is clear that insider trading is not without its victims. It is specious to say that investors should be deprived of the fair market value of their investments merely because profits were not anticipated. Logic dictates that the insider's limited transactions more often than not will not cause the market price to adjust to reflect the true impact of the undisclosed information. That, in fact, is how we are able to measure "ill-gotten gains" to establish disgorgement and damages. The net result? The insider benefits, usually in a big way, the investor on the other

side of his trade is hurt, and there is no perceptible gain for the market.

In addition, those who believe that the integrity of the marketplace is not harmed by trading on material non-public information do not take into account the fact that other market participants, including issuers, market makers and specialists, are harmed by those who trade on inside information. Take, for example, the specialist who is obligated by statute and exchange rules to maintain a fair and orderly market. Most frequently, this is achieved by assuring that there will always be buyer or seller for their speciality stock. But how can the specialist make reasonable judgments about the pricing of a security, and thereby avoid losses, if market activity is tainted by the trading of someone with material non-public information? The result can be, and often is, that irreparable harm is done to these market professionals. It is simply ignorance or naivete' that leads one to think that no one is harmed by this type of activity.

Economists' View of the Efficiency Issue

Economists argue that another benefit of allowing insider trading is that, from a social point of view, insiders are likely to be the most efficient producers of trading information. According to this argument, the amount of information produced by investment advisory services and others will be greater if insiders are allowed to trade on material non-public information. Since real resources are used to produce this information and since insiders can "produce" this information more cheaply than outsiders, it is argued that one effect of

regulation is to raise the costs of producing trading information, which, from a social point of view, is inefficient.

Yet another assumed benefit of legalized insider trading is that it is an effective way for a firm to signal valuable information to the market, thereby enhancing the efficiency of the market. Voluntary disclosure of some information may not be in the interests of shareholders, yet it may be in the interests of shareholders to signal the general nature of this information to the market. It is argued that in those instances where disclosure of information may at times be premature due to perhaps competitive pressures or maybe uncertainty, if insiders are permitted to trade on this information, the market will adjust itself to take account of the undisclosed information and securities prices will approach their true worth.

Once again, the economists confuse their hypothetical world with reality. In this instance, they ignore the difference between trading by insiders and "insider trading" deemed violative of Section 10b-5 of the Securities Exchange Act of 1934. Trading by insiders is by no means proscribed. To the contrary, our system permits and even encourages insiders to trade in their companies' securities, and there is no doubt that such trading does, more or less efficiently, signal information on trends or attitudes to the marketplace. Trading by insiders is not secret, it is required to be disclosed whenever it occurs. Thus, not only does the market have the benefit of knowing about the trading of insiders, but also the information on which insiders are trading is generally disseminated to the investor by the company and/or analysts and

other market professionals privy to the information known to corporate management and savvy enough to understand its significance. In further response to the efficiency argument, I think that corporate management would be in the best position to know whether insider trading is the most cost effective way to disseminate information to the investing public, and they have concluded that it is not, as reflected by their internal rules against insider trading and their support of the SEC's campaign against it.

Another presumed economic disadvantage of insider trading posited by the economists is that a major effect of the "disclose or abstain" rule is to delay the flow of information to the market. If the flow of information is delayed, then resource allocation is impaired, since mispriced securities will be transacted to a greater degree than would otherwise be the case. Thus, the ecomonists argue that restrictions on insider trading contribute to the mispricing of securities, as a result of which some investors will sell before good news is disclosed and buy before bad news is disclosed.

There is a fatal flaw in this argument--one which should be obvious to anyone--that being that insider trading is premised on withholding information from the market. It is only when the material information is non-public that the trader is assured of gaining his profit or avoiding his loss. Therefore, it is far more logical to conclude that unrestricted insider trading would increase the delay of the flow of information to the market rather than reduce it, but then I have concluded that economists are more interested in method and statistics rather than logic.

With Respect to the Traditional View that Corporate
Managers Have a Fiduciary Duty Not to Trade on Inside Information

In a nutshell, economists argue that the opportunity to trade on material non-public information is a matter to be determined by means of private contract between a firm and its managers. Legalized insider trading would simply allow the use of insider information to be determined as part of a manager's compensation package. If insider trading, generally, and short selling, in particular, are inefficient forms of compensation, then, economists argue, the competitiveness of the capital market and the managerial labor market will ultimately eliminate insider trading as a form of compensation. Thus, economists argue, competitive pressures lead firms to adopt compensation schemes that maximize shareholder value; if the net effect of insider trading is injurious to shareholders, then private contracts will ensure its extinction.

Although the spirit of this argument has great appeal to all economists, it rests on the assumption that directors who establish corporate compensation plans act as perfect fiduciaries for shareholders in this role. This argument assumes that a by-product of this compensation scheme is that managers would tend to maximize the value of their corporation because they have a greater stake in it. The argument, however, does not address the fact that both good management, as well as bad, is rewarded when an insider trades prior to the public disclosure of either promising or adverse information. To the extent that there is a divergence between the directors' interests and the shareholders' interest on this issue, and to the extent that the director is able to escape the discipline of the market when inefficient compensation

plans are adopted, then these economists' arguments are weakened considerably. Moreover, since both good managers and bad alike receive corporate information, regardless of their individual efforts, compensation is not limited, as the economists' argument goes, to those who generate valuable information. Furthermore, the magnitude of such entrepreneurial compensation is in no way limited to the manager's efforts, but rather, to the size of his investment and the prevailing market conditions. Finally, and perhaps most importantly, the market has already determined that profits from insider trading is not the most fair and efficient method of compensating corporate managers. That conclusion was reached over 50 years ago and has steadily been reinforced by experience.

The SEC's Role in the War Against Insider Trading

In 1934, in the preamble to the Securities and Exchange Act, Congress gave the SEC a mandate--the Commission was ". . . to provide for the regulation of the securities exchanges and . . . markets to prevent inequitable and unfair practices . . ." It was very early on that the Commission recognized that insider trading was one of the most destructive activities, with enormous potential to undermine investor confidence in our financial markets. As a result, pursuant to its rulemaking authority, Rule 10b-5 was adopted in 1942, embodying general notions of fairness. Rule 10b-5, a general anti-fraud provision, is still the Commission's number one tool in the war it is waging against insider trading. Of late, we have intensified our efforts in pursuing insider trading through the vigorous work of our Division of Enforcement.

As a result, the Commission has brought 55 cases against insiders since 1981--a marked increase over earlier years. In fact, from 1934 through 1978, only 40 cases were brought against insiders. You may be familiar with such notable and newsworthy cases such as the Wall Street Journal matter, which involved a financial newspaper columnist who leaked information about upcoming stories and then, along with his tipees, traded on that information. Or perhaps you've heard about the recent case in which a proof-reader at a New York law firm gathered confidential information concerning pending mergers from the firm's files. The proofreader then passed that information on to some of his friends, including a cab driver. Recently, you may have even read that a number of the individuals in this matter were sentenced criminally and ordered to make disgorgement of their ill-gotten gains. Similarly, a federal grand jury recently indicted a former employee of the law firm of Sullivan & Cromwell in New York, as well as seven other individuals, for illegally misappropriating confidential information and then trading on that information.

Historically, in the civil forum, the Commission has been successful in obtaining injunctions against future violations by insiders, as well as securing disgorgement of their ill-gotten gains. Moreover, working in conjunction with the Department of Justice, the Commission has been successful in criminally prose-cuting those who trade on inside information. In the past two to three years, 40 of the Commission's cases have served as the basis for criminal prosecutions in the Southern District of New York.

In addition, we are gradually overcoming some of the stumbling blocks encountered when insiders hide behind foreign secrecy and blocking laws. Secrecy statutes protect private interests in bank records abroad, such as the identity of a bank customer. Blocking laws protect a national interest by prohibiting the disclosure, copying, inspecting or removal of documents located in the territory of the enacting state. We're making progress in this area. In 1982, the Commission entered into an agreement with the Swiss government. Our Memorandum of Understanding fosters cooperation between the United States and Switzerland by virtue of the exchange of law enforcement information when the conduct being investigated is violative of the laws of both countries.

Furthermore, the Commission recently started down a new avenue in the hopes of overcoming the adverse ramifications of the blocking and secrecy statutes. In July, 1984, the Commission sought public comment concerning implementation of a "Waiver By Conduct" concept as a possible response to problems engendered by secrecy laws. Under this innovative approach, the purchase or sale of securities in the U.S. would constitute an implied consent to the disclosure of information and evidence relevant to the transaction for purposes of any Commission investigation or legal action. If this concept is adopted eventually, it may break down one more wall behind which insiders have been able to hide in the past.

Finally, of great significance, was the recent Congressional enactment of the Insider Trading Sanctions Act. The act

promises to raise the stakes of insider trading and serve as yet one more deterrent to those who dabble in the markets while in possession of material non-public information. Signed into law by the President on August 10, 1984, the Commission now has the authority to seek three times the profits gained or the losses avoided as a result of purchases or sales made on the basis of inside information.

Conclusion

Insider trading is wrong. I've shown that the economists' hypothesis is untenable and that investors, and the marketplace in general, are truly hurt by those who misappropriate material non-public information to their own benefit. I concede that the fight against insider trading is a difficult and seemingly unending battle, but it is one I believe must be fought. With new tools at the Commission's disposal and the development of new approaches to aid in the fight against insider trading, I think that the Commission will eventually win the war.

Well -- I thank Professors Manne and Moran for providing me with a few straw men to knock down tonight and I thank you for your patience and attention.