

## Insider trading

What's legal? What's illegal?  
How is it regulated? How *should* it be regulated?

### Court Rejects Bharara's Plea to Reconsider Trading Ruling - New York Times, April 5, 2015

On Friday [April 3], the United States Court of Appeals for the Second Circuit [refused] ... to reconsider a ruling in December that sharply narrowed the definition of insider trading.

That ruling, issued by a three judge panel of the court, tossed out the convictions of two hedge fund traders and threatened to dissolve other signature convictions and pleas secured by the office of Mr. Bharara, the United States attorney for Manhattan.

## Outline

- ❑ “Legal” insider trading
- ❑ “Illegal” insider trading
  - Legal framework and principles
  - Economic arguments for and against.
- ❑ Readings
  - Bainbridge, Stephen M. (2000). Insider trading: an overview. SSRN. <http://ssrn.com/abstract=132529>
  - Pages 1-(top of) p. 5. Morrison-Foerster, LLP. (2015). 2014 Insider Trading Annual Review. Morrison-Foerster, LLP. <http://www.mofo.com/~media/Files/ClientAlert/2015/02/150211InsiderTradingAnnualReview.pdf>

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## Legal “insider trading”

- ❑ The classic “insider” is a company officer, director or owner of 10% or more of the shares.
- ❑ These people must report their trades to the SEC within two days.
  - These reports are made public on EDGAR.
- ❑ The trades can’t rely on material non-public information.
- ❑ They can’t sell short.
- ❑ Any profits realized from buying and selling within a six-month period are considered *short-swing profits*.
  - The corporation or any security holder can sue to recover these profits.

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## Illegal insider trading

- ❑ Trading on inside information in the US is subject to civil action (SEC) and criminal charges (Department of Justice)
- ❑ No US law explicitly defines and prohibits “insider trading”
- ❑ The prohibitions and prosecutions rest on interpretations of Rule 10b-5 that have been advanced by the SEC and affirmed in court rulings.
  - Insider trading is considered a “manipulative and deceptive” device under the rule.
- ❑ Some of the key legal principles that have emerged in this fashion include
  - The rule of “disclose or abstain”.
  - Duty of confidentiality.
  - Misappropriation of information.
  - Tipper-tippee liability.

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## Disclose or abstain

- ❑ Someone in possession of material non-public information must either disclose the information to their trading counterparty or abstain from trading.
- ❑ Consistent with the fairness principle of equal access to information.
- ❑ SEC v. Texas Gulf Sulfur
  - In 1964, Texas Gulf Sulfur, a mining company, determined that a field in Ontario was especially valuable. The information was made public on April 15, but officers and employees (insiders) started buying days (months) before the announcement.
  - The SEC brought a complaint and obtained a judgment against the defendants.
- ❑ Disclosure is often impossible, so abstaining is the only option.
- ❑ How broad is this? Does it apply to *any* informational advantage, however obtained?
- ❑ The disclose or abstain principle was restrained by imposing a requirement based on a duty of confidentiality.

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## Fiduciary duty of confidentiality

- ❑ A “fiduciary duty” is a legal obligation to act on behalf of someone else.
- ❑ A duty to disclose only exists if the information was obtained through a relationship of trust.
- ❑ *Chiarella v. U.S. (1980)*
  - Chiarella worked for a financial printer. In printing documents for corporate acquirers, he determined the identities of target firms. He purchased the stock prior to the announcement.
  - Chiarella (an *outsider*) was convicted, but the Supreme Court reversed the conviction on the grounds that he had no fiduciary relationships *to the target companies or their stockholders*.

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## Misappropriation of information

- ❑ Even though you might not have a fiduciary relationship with the stockholders, you might have obtained the information through some other fiduciary relationship.
- ❑ Some early attempts to apply this theory failed, but the courts later adopted this principle.

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- ❑ An early case: *Carpenter v. US* (1987)
  - R. Foster Winans was a reporter for the Wall Street Journal.
  - His “Heard on the Street” column mentioned stocks, and these mentions often moved prices.
  - He tipped off a stock broker in advance of publication.
  - The SEC alleged that he misappropriated the information in violation of a duty owed to his employer.
  - The Supreme Court rejected this theory.
- ❑ Did Chiarella misappropriate information from *his* employer?

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- ❑ A defining case: *US v. O'Hagan* (1997)
  - In 1988, Grand Metropolitan planned to take over Pillsbury.
  - Grand Met retained the law firm of Dorsey & Whitney.
  - James O'Hagan was a partner in the firm. He didn't work on the takeover, but he did learn of it, and bought Pillsbury shares.
  - Convicted on the grounds that he misappropriated information from his employer (Dorsey & Whitney)

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## §240.10b5-1 clarifies the *SEC*'s definition of insider trading.

- ❑ The “manipulative and deceptive devices” ... include, among other things, the purchase or sale of a security of any issuer, on the basis of material nonpublic information about that security or issuer, in breach of a duty of trust or confidence that is owed directly, indirectly, or derivatively, to the issuer of that security or the shareholders of that issuer, or to any other person who is the source of the material nonpublic information.

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## When does a duty of trust or confidence arise?

- ❑ Established business relationship
  - Lawyer-client (O'Hagan)
  - Investment banker-client
- ❑ Other professional relationships?
- ❑ Family relationship?
- ❑ Professional friendships?
- ❑ Personal friendships?

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## The case of the stock-buying psychiatrist (currentpsychiatry.com)

### MALPRACTICE RX

#### When your patients disclose 'insider information'

Vol. 11, No. 12 / December 2012



**Douglas Mossman, MD**

*Dr. Mossman is Professor and Program Director, University of Cincinnati Forensic Psychiatry Fellowship, Cincinnati, OH*

*Dear Dr. Mossman:*

*My patient is an officer in a large corporation. During therapy, he sometimes talks about how the company is doing. Would I risk malpractice liability if I used this information in managing my retirement investments?*

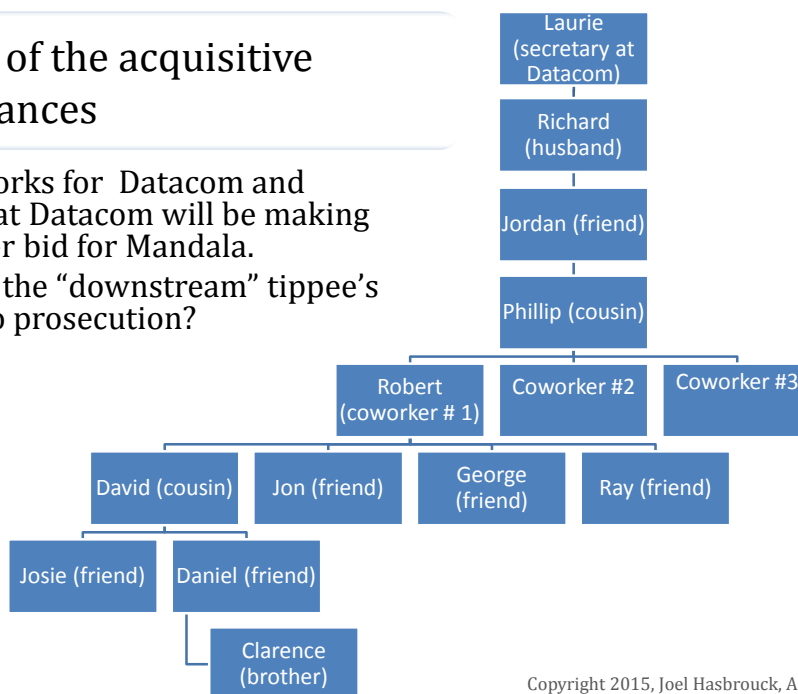
*Submitted by "Dr. B"*

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## The case of the acquisitive acquaintances

- ❑ Laurie works for Datacom and learns that Datacom will be making a takeover bid for Mandala.
- ❑ Are all of the "downstream" tippee's subject to prosecution?



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## The case of the well-situated seller.

- ❑ Mona holds stock in IMC where her friend, Stephen is CEO.
- ❑ Stephen discovers bad news and sells a large block of IMC.
- ❑ Mona and Stephen use the same stockbroker, Phillip.
- ❑ Philip tells Mona that Stephen has sold.
- ❑ Mona quickly sells her IMC stock.
- ❑ IMC announces the bad news and its stock falls.
- ❑ Insider trading?

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## The case of the rueful room mate

- ❑ Amy is an analyst for Cubic Investments (a hedge fund)
- ❑ Amy is working on a plan for Cubic to short-sell stock in GreenGrow.
- ❑ Bianca (Amy's room mate) learns about the plan. Amy tells Bianca that the information is confidential and that Bianca shouldn't trade on it.
- ❑ Bianca tells her friend Caitlin about the plan. Caitlin buys put options on GreenGrow.
- ❑ Insider trading?

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## What does the tipper (source of the information) receive?

- ❑ If the information is material (economically valuable), and if the tipper is knowingly violating a duty of confidentiality and taking a risk of discovery and prosecution, we'd expect that the tipper be receiving payment or other consideration.
- ❑ Is some payment (or other benefit) a *necessary* condition for alleging insider trading?

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## Dirks v. SEC (1983)

- ❑ Background
  - Raymond Dirks was an investment analyst who covered insurance companies.
  - Ronald Secrist was a former executive at Equity Funding of America.
  - Secrist told Dirks that Equity's accounting was fraudulent.
  - Dirks investigated; some Equity employees corroborated Secrist's statements.
  - Dirks told his clients (who sold). Equity's stock price dropped. Trading was halted. The firm went into receivership.
- ❑ The SEC censured Dirks for abetting (assisting, facilitating) trading on material nonpublic information (in violation of "disclose or abstain").
- ❑ The US Supreme Court reversed the censure on the grounds that neither Secrist nor the corroborating employees received any monetary or personal benefit.
  - Simply passing along the information did not violate a duty of confidentiality.

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## SEC v. Obus (2012)

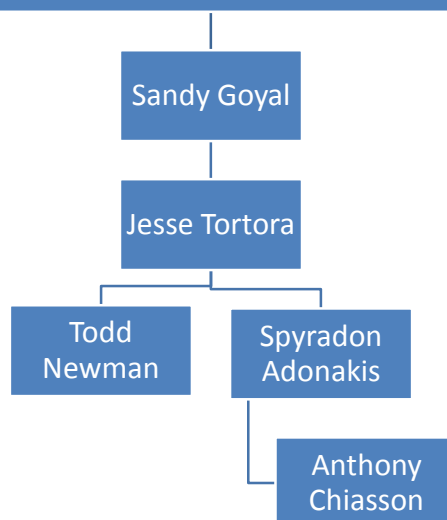
- ❑ In 2012, a decision by the Court of Appeals for the Second Circuit in *SEC v. Obus* expanded tippee/tipper liability – at least in SEC civil enforcement actions – to encompass cases where neither the tipper nor the tippee has actual knowledge that the inside information was disclosed in breach of a duty of confidentiality.
- ❑ Rather, a tipper's liability could flow from recklessly disregarding the nature of the confidential or nonpublic information, and a tippee's liability could arise in cases where the sophisticated investor tippee should have known that the information was likely disclosed in violation of a duty of confidentiality.
- ❑ (Morrison and Foerster, 2014 Insider Trading Review)
- ❑ Obus *seemed* consistent with a very broad interpretation of insider trading.
  - But then came Chiasson and Newman ...

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- ❑ United States vs. Anthony Chiasson and Todd Newman
- ❑ Charged January, 2012
  - "... as sophisticated traders, they must have known that information was disclosed by insiders in breach of a fiduciary duty, and not for any legitimate corporate purpose."
- ❑ Convicted December 2012
- ❑ Conviction overturned December, 2014
- ❑ SEC appeal denied April, 2015

Rob Ray (Investor Relations, Dell) passes along advance earnings information.



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## From the decision overturning the conviction:

- ❑ In order to sustain a conviction for insider trading, the Government must prove beyond a reasonable doubt that the tippee knew that an insider disclosed confidential information and that he did so in exchange for a personal benefit.
- ❑ Moreover, we hold that the evidence was insufficient to sustain a guilty verdict against Newman and Chiasson for two reasons.
  - First, the Government's evidence of any personal benefit received by the alleged insiders was insufficient to establish the tipper liability from which defendants' purported tippee liability would derive.
  - Second, even assuming that the scant evidence offered on the issue of personal benefit was sufficient, which we conclude it was not, the Government presented no evidence that Newman and Chiasson knew that they were trading on information obtained from insiders in violation of those insiders' fiduciary duties.

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## Insider trading regulation: the arguments (Bainbridge)

- ❑ Henry Manne (1966) *Insider trading and the stock market*
- ❑ Insider trading benefits society because
  - It makes markets more efficient (more private information gets incorporated into the security price)
  - Insider trading is an efficient way to compensate managers.

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## Efficiency

- ❑ We want managers to produce information.
- ❑ If this information can't be publicized, the stock price won't be accurate.
- ❑ BUT
- ❑ Insiders probably can't buy/sell enough stock to really move the price all the way to its "correct" value.
- ❑ The market has to infer the insider's trading activity from watching the order flow.
  - The adjustment process is rough and prone to errors.

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## Compensation

- ❑ What better way to compensate managers than by letting them profit from the information that they produce?
- ❑ BUT
- ❑ Isn't this information the property of all the shareholders?
- ❑ If the information is negative, the manager can profit by selling short.
  - Does this give the manager an incentive for poor performance?
- ❑ Why should insider trading result in the correct level of managerial compensation?

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## Arguments in favor of regulation

- Fairness
  - The insider didn't produce the information – they just happened to be in the right place at the right time.
- Economic arguments (Bainbridge)
  - Insider trading harms investors and hurts investor confidence.
  - Insider trading harms the issuer.
  - Insider trading involves theft of information.

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## Insider trading harms investors and hurts investor confidence

- When an insider buys from me in the basis of private information worth \$5, I've lost \$5.
  - Bainbridge: but you'd have lost from the sale to anyone; all purchasers have a gain (not just the insider)
  - *Inside information leads to trading costs for all investors.*
- Bainbridge: many countries with weak insider trading prohibitions still seem to have active liquid stock markets.
  - *Might these markets be even better with regulation.*

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## Insider trading hurts the issuer

- ❑ Insiders will delay the public release of information until they've been able to trade.
  - Bainbridge: trading can be accomplished very quickly.
  - *Not for all stocks.*
- ❑ Interference with corporate plans.
  - An insider buying a takeover target might drive the price up for the acquirer.
  - An insider might disclose information early to realize his trading profit.

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- ❑ Insider trading is theft.
  - Information is property: the gains from using that information belong to the producer of that information (the corporation).
  - Bainbridge: the value of information is not reduced when more than one person uses it.
  - *In financial markets, it can.*

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## Are (reported) insider trades profitable?

- ❑ Insiders must report their trades to the SEC within two days. Are their trades profitable?
  - After they bought, did the stock go up? After they sold, did it go down?
- ❑ Most studies have found that insider trades are slightly profitable.
  - Insiders exploit a small information advantage.

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## SEC rules provide insiders with a *safe harbor*.

- ❑ ... [A] person's purchase or sale is not “on the basis of” material nonpublic information if the person making the purchase or sale demonstrates that:
- ❑ (A) Before becoming aware of the information, the person had:
  - (1) Entered into a binding contract to purchase or sell the security,
  - (2) Instructed another person to purchase or sell the security for the instructing person's account, or
  - (3) Adopted a written plan for trading securities;

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## 10b5-1 Plans

- ❑ Written agreements that pre-commit an executive to buy or sell shares.
  - Usually specify a regular schedule or purchases or sales.
- ❑ Widely used by executives to divest shares over time.
- ❑ But the plan doesn't have to be filed with the SEC, doesn't have to be publicly available, and can be changed at will.
- ❑ This allows an insider to sell a "larger than planned" amount to avoid holding the stock prior to the announcement of bad news.
- ❑ There is evidence that directors are doing just that.
  - Pulliam, Susan, & Barry, Rob. (2013, April 25, 2013). Directors take shelter in trading plans, Wall St. Journal.

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## Decoding inside information<sup>1</sup>

- ❑ One study separates routine trades and opportunistic trades.
- ❑ "[A] routine trader [is] an insider who placed a trade in the same calendar month for at least a certain number of years in the past. ... [An] opportunistic traders [is] everyone else."
- ❑ "A portfolio strategy that focuses solely on 'opportunistic' traders yields value-weighted abnormal returns of 82 basis points per month, while abnormal returns associated with routine traders are essentially zero.

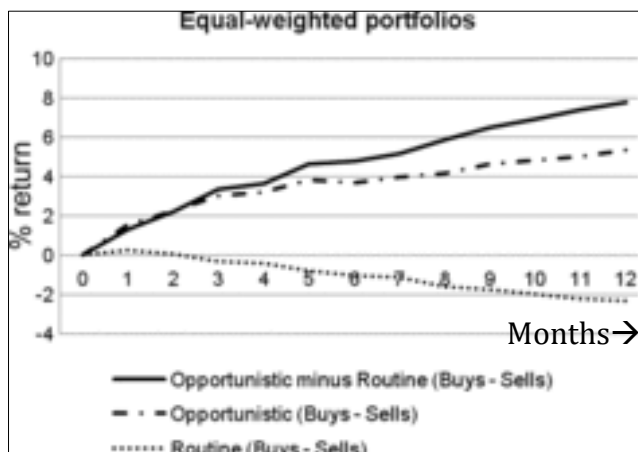
(1) Cohen, Lauren, Malloy, Christopher, & Pomorski, Lukasz. (2012). Decoding Inside Information. The Journal of finance, 67(3), 1009-1043.

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- Track stock performance in the days following routine and opportunistic trades, and report the average
  - This corresponds to forming an equal-weighted portfolio of the stocks.
- Opportunistic trades are much more profitable
  - ... and are more likely to trigger an SEC investigation.



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