

Securities Trading: Principles and Procedures

Chapter 12

Insider trading

What's legal? What's illegal?
Should we legalize all of it?

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Readings (NYU Classes: Resources → Readings: Insider Trading)

- (Bainbridge-2012.pdf) Bainbridge, S. M. (2012). An overview of insider trading law and policy: An introduction to the insider trading research handbook. Research Handbook on Insider Trading. S. M. Bainbridge, Edward Elgar. (pp. 1-11, 24-28).
- (Bainbridge-2001Marked.pdf) Bainbridge, S. M. (2001). The law and economics of insider trading: a comprehensive primer.
Only the sections highlighted in yellow: these give a bit more detail on the actual cases.
- (The Martoma Decision - The Second Circuit Tackles Insider Trading Post-Salman.pdf) Miller, D. I.; K. I. Schacter; and G. R. MacQueen. The Martoma Decision: The Second Circuit Tackles Insider Trading Post-Salman. MorganLewis (2017).
- Background reading (not required)
(13-1837_opn 2nd Circ Court Opinion in Chiasson Newman.pdf)
Second Circuit Court Opinion in US v. Newman, Chiasson (2014).

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The "classic insider"

- Company officer, director or owner of $\geq 10\%$ of the shares.
- Must report their trades to the SEC within two days.
 - Reports are available online on EDGAR.
 - Can't rely on material non-public information.
 - 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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SEC Form 4
FORM 4

UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

STATEMENT OF CHANGES IN BENEFICIAL OWNERSHIP

OMB APPROVAL

OMB Number: 3235-0287

Estimated average burden hours per response: 0.5

Check this box if no longer subject to Section 16. Form 4 or Form 5 obligations may continue. See Instruction 1(b).

Filed pursuant to Section 16(a) of the Securities Exchange Act of 1934 or Section 30(h) of the Investment Company Act of 1940

1. Name and Address of Reporting Person* <u>Koum Jan</u> (Last) (First) (Middle) C/O FACEBOOK, INC. 1601 WILLOW ROAD (Street) MENLO PARK CA 94025 (City) (State) (Zip)		2. Issuer Name and Ticker or Trading Symbol <u>Facebook Inc [FB]</u> 3. Date of Earliest Transaction (Month/Day/Year) 03/23/2017 4. If Amendment, Date of Original Filed (Month/Day/Year)		5. Relationship of Reporting Person(s) to Issuer (Check all applicable) <input checked="" type="checkbox"/> Director 10% Owner Officer (give title below) Other (specify below)	
				6. Individual or Joint/Group Filing (Check Applicable Line) <input checked="" type="checkbox"/> Form filed by One Reporting Person <input type="checkbox"/> Form filed by More than One Reporting Person	

Table I - Non-Derivative Securities Acquired, Disposed of, or Beneficially Owned

1. Title of Security (Instr. 3)	2. Transaction Date (Month/Day/Year)	2A. Deemed Execution Date, if any (Month/Day/Year)	3. Transaction Code (Instr. 8)		4. Securities Acquired (A) or Disposed Of (D) (Instr. 3, 4 and 5)			5. Amount of Securities Beneficially Owned Following Reported Transaction(s) (Instr. 3 and 4)	6. Ownership Form: Direct (D) or Indirect (I) (Instr. 4)	7. Nature of Indirect Beneficial Ownership (Instr. 4)
			Code	V	Amount	(A) or (D)	Price			
Class A Common Stock	03/23/2017		s ⁽¹⁾		65,353	D	\$140.0524 ⁽²⁾	13,070,453	I	By Jan Koum, Trustee of The Butterfly Trust U/A/D 1/20/2004 ⁽³⁾

Explanation of Responses:

1. The sales reported on this Form 4 were effected pursuant to a Rule 10b5-1 trading plan adopted by the holder.

From Spotify's F-1 Registration Filing

- Risks Related to ... Our Status as a Foreign Private Issuer
- ... [We] are exempt from a number of U.S. securities laws and rules ... and are permitted to publicly disclose less information than U.S. companies must.
- ... [We] are not subject to all of the disclosure requirements applicable to companies organized within the United States.
- ... *[Our] officers and directors are exempt from the reporting and "short-swing" profit recovery provisions ... and related rules with respect to their purchases and sales of our securities.*
 - *For example, some of our key executives may sell a significant amount of ordinary shares and such sales will not be required to be disclosed as promptly as companies organized within the United States would have to disclose. Accordingly, once such sales are eventually disclosed, our ordinary share price may decline significantly.*
- ... [We] are not required to file periodic reports and financial statements with the SEC as frequently or as promptly as U.S. public companies.
- We also are not subject to Regulation FD ...

Analysis of *reported* insider trades

- Are trades reported on Form 4 (on average) profitable?
 - After they buy, does the stock go up?
After they sell, ... down?
- Most studies find that insider trades are slightly profitable.
 - Insiders exploit a small information advantage.
- Next: screenshot from insider-monitor.com

Secure | https://www.insider-monitor.com/insider_stock_trading_report.html

Inbox (1,691) - jhasi | Home - Program in | Home - Google Play | The 100 Best Movies | Cases - Review, Pro | New York University | ScholarOne Manus | Joel Hasbrouck | NYU Classes | My Wi | Maps | Home

Realtime Insider Trading Report - all trades (page 1 of 2)

Insider all trades reported on **April 3, 2018**

Page:

Note: **B**: Buy; **S**: Sale; **O**: Option Exercise.

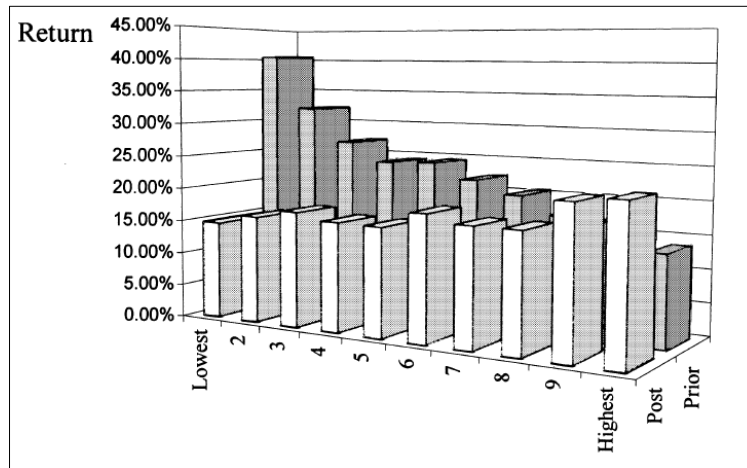
Symbol	Company	Insider Name	Trade Type	Shares	Price	Value(\$)	Time	Trade Date
SBOT	Stellar Biotechnologies, Inc.	Morse Daniel E.	S	4,366	.81	3,514	06:11:25	2018-03-29
EVBG	Everbridge, Inc.	Goldman Kenneth S (SVP, CFO and Treasurer)	S	10,327	35.77	369,345	06:16:18	2018-04-02
		Mark Elliot J. (SVP & General Counsel)	S	1,000	35.79	35,792	06:18:27	2018-04-02
		Mouline Imad (SVP & Chief Technology Officer)	S	2,100	32.00	67,200	06:19:33	2018-01-18
		Mouline Imad (SVP & Chief Technology Officer)	S	5,000	33.03	165,140	06:19:33	2018-01-19
		Mouline Imad (SVP & Chief Technology Officer)	S	3,000	35.78	107,340	06:20:26	2018-04-02
LOW	Lowes Companies Inc	Croom Marshall A (Chief Financial Officer)	O	2,830	.00	0	07:49:57	2018-04-01
		Hollifield Matthew V (SVP Chief Accounting Officer)	O	1,644	.00	0	07:52:33	2018-04-01
		Maltsbarger Richard D (Chief Operating Officer)	O	3,557	.00	0	07:55:32	2018-04-01
LTS	Ladenburg Thalmann Financial Services Inc.	Lampen Richard (President and CEO)	B	5,000	3.10	15,475	07:55:51	2018-04-02

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The net (insider) purchase ratio

- Lakonishok, J. and I. Lee (2001). "Are Insider Trades Informative?" *The Review of Financial Studies* 14(1): 79-111.
- $NPR = \frac{\#purchases - \#sales}{\#purchases + \#sales}$, over the prior year.
- L&L form portfolios based on NPR:
 - Low (negative) NPR → insiders have been selling.
 - High (positive) NPR → ... buying
- How well do these portfolios perform over the *following* year?

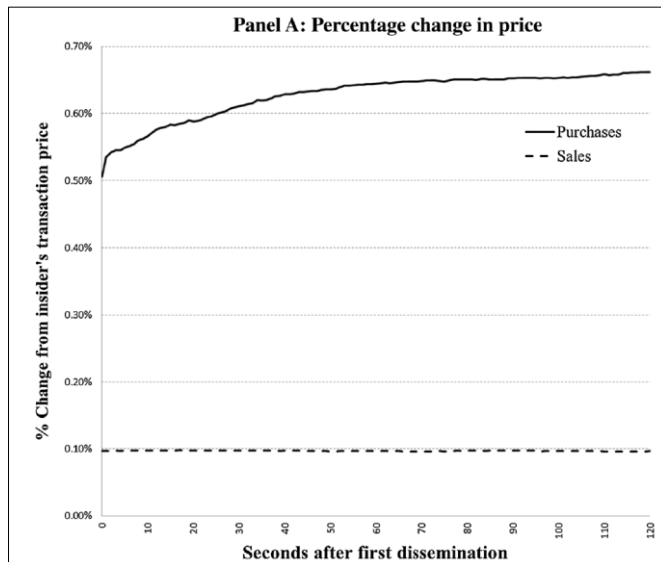
Lakonishock and Lee, Figure 2



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How soon does the market react to the insider filings?



Rogers, J. L., D. J. Skinner and S. L. C. Zechman (2016). "The role of the media in disseminating insider-trading news." *Review of Accounting Studies* 21(3): 711-739.

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Facebook/Koum Jan Form 4 refers to a “10b5-1 plan”

- SEC rules provide managers with a safe harbor.
 - Safe harbor: a part of a law that says certain behavior will not be considered a violation.
- A 10b5-1 plan is a written agreement that pre-commits an executive to buy or sell shares.
 - Usually specifies a regular schedule of purchases or sales.
- Widely used by executives to divest shares over time.

Do 10b5-1 plans actually *encourage* insider trading?

- A 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.

Illegal insider trading

- Trading on inside information in the US may lead to civil action (SEC) and/or criminal charges (Department of Justice)
 - Some cases have led to convictions and jail (Martha Stewart)
 - Other cases have failed (Steven A. Cohen)
- No US law clearly defines “insider trading”
 - Insider trading is a “manipulative and deceptive” device under rule 10b-5.
- Instead: accumulation of *case law*
 - Legal principles and precedents derived from past rulings.

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Illegal inside information: a special case of private information

- Information → efficient prices → “signals” for investors.
 - Tesla stock has a high value → Tesla can easily raise money for new projects.
 - Stock of poorly-managed firm has low value → firm couldn’t easily raise money.
- Information production is costly.
- Informed investors offset the cost by profitable trades against uninformed investors.
- Uninformed traders benefit from efficiency.
 - Their losses to informed traders are a kind of tax that subsidizes the production of information.

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What is the value in what “informed traders” do?

- What does it cost them to produce the information? How much do they make?
 - Their profits are a *private* benefit.
- How much does their information really contribute to efficiency?
 - Do their trades help society allocate resources more efficiently?
 - These efficiency gains are *social* benefits.
- Do high private benefits inevitably lead to high social benefits?

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The debate in the political arena

- Senator: “Why should we allow hedge funds, high-frequency traders, and others to make so much money?”
- Trader: “Based on education, experience, judgement, and large expenditure on people and technology, I/we produce information.

This information might yield a small profit for myself/ourselves, but great benefits for society in the form of more efficient security prices.”

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The private and social value of information. Examples.

1. An investment fund analyzes solar energy technology ...
 - And uses the information to make long-term investments.
2. A fund analyzes which solar energy companies are likely to be takeover targets.
 - And uses the information in short-term merger arbitrage strategies.
3. A high-frequency trader learns about a takeover 4 milliseconds faster because it pays \$5,000 per month for a “low-latency” news feed ...
 - And hits/lifts bids/asks before they can be cancelled or revised.
4. An investment bank intern learns from a director that a certain tech company is going to be takeover target ...
 - And buys stock ahead of the announcement.

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In each case ...

- ❑ Private information is produced (with cost/effort).
- ❑ The trade is (privately) profitable.
- ❑ The trader:
 - “Once I’ve traded, the price will better reflect all the information.”
 - “I’ve made the market more efficient.”
- ❑ What’s the social value? Where does it come from? Should uninformed investors be paying for it?
- ❑ Should it be illegal to use certain kinds of information?

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The legal problem

- ❑ Case 1: An investment fund produces fundamental information and makes long-term investments.
 - (Usually) legal.
- ❑ Case 4: An investment bank intern buys stock ahead of a takeover announcement.
 - Clearly illegal.
- ❑ How can we distinguish between these two possibilities?

Key principles/aspects of the insider trading law

- ❑ Disclose or abstain
- ❑ Fiduciary duties
- ❑ Tipping
- ❑ Misappropriation of information.
- ❑ Personal benefit

Cady, Roberts (1961)

- ❑ The board of the Curtiss-Wright Corporation votes to reduce the dividend.
- ❑ Cheever Cowdin is a director of Curtiss-Wright ...
 - And a partner at Cady, Roberts (a brokerage firm)
- ❑ Cowdin tells Robert Gintel (another partner);
- ❑ Gintel sells Curtiss-Wright in customer accounts.
- ❑ The cut is announced; the stock drops; Gintel's customers avoid losses.
- ❑ The SEC charges Gintel with insider trading.

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The trial

- ❑ Cady, Roberts is a brokerage firm.
- ❑ Brokerage firms are regulated by the SEC.
- ❑ The SEC's insider trading case against Gintel is treated as an "administrative" case.
 - The SEC and Gintel's attorneys argue the case in an internal SEC proceeding.
 - An Administrative Law Judge (an SEC employee) hears the case.
- ❑ The decision goes against Gintel.

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Disclose or abstain: the SEC's position

- Gintel is at fault because he violated the principle of disclose or abstain.
 - Anyone in possession of material non-public information must either disclose the information to their trading counterparty or abstain from trading.
- Markets should be fair.
 - “Fair”: all investors should have equal access to information.

Texas Gulf Sulfur (1964)

- Texas Gulf Sulfur, a mining company, determines that a field in Ontario is especially valuable.
 - Officers and employees (insiders) start buying.
 - The information is later publicly announced.
- The SEC brings a complaint and obtains a judgment against the insiders.
 - The judgment is affirmed (upheld) by the US Court of Appeals.
 - (The decision in Cady, Roberts was only an *administrative* ruling.)
- Disclosure is often impossible, so abstaining is the only option.
- Does disclose or abstain apply to *any* informational advantage?

Side note: disclosure in Texas Gulf Sulfur

- After the discovery (and while insiders were buying) there are rumors about the discovery.
 - TGS denies the rumors.
- Most 10b-5 cases involve failure to disclose bad news.
 - Buyers of the stock are hurt.
- TGS fails to disclose good news.
 - Sellers are hurt.

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“Disclose or abstain” seems very broad

- Does it apply to any informational advantage?
 - An advantage based on superior financial analysis?
- Recall that a classic insider (officer, director) has an obligation to the shareholders.
 - Such a “fiduciary relationship” involves trust and confidentiality.
- The next case says that “disclose or abstain” only applies when there is a fiduciary duty.

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Chiarella (1980)

- ❑ Vincent Chiarella works for a financial printer.
- ❑ In printing documents for corporate acquirers, he figures out the identities of target firms.
- ❑ He purchases the stock prior to the announcement.
- ❑ The SEC charges him with insider trading; he is convicted.
- ❑ The Supreme Court reverses the conviction:
 - He has no fiduciary obligations *to the target companies or their stockholders*.
- ❑ In *Chiarella*, the only relationship that matters is between the trader and the holders of securities being traded.

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Tipping

- ❑ In many cases, the trader learns something from someone else.
- ❑ In *Cady, Roberts (1961)*, Cheever Cowdin is the *tipper*, and Robert Gintel is the *tippee*.
 - Gintel sells in *customer* accounts (acting on their behalf).
 - The SEC charges Gintel with insider trading using the disclose or abstain rule.
- ❑ How would *Cady, Roberts* have been viewed after *Chiarella*?
 - Where was there a violation of a fiduciary duty?

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Dirks (1983)

- ❑ Raymond Dirks was a securities analyst who covered insurance companies.
- ❑ Ronald Secrist, a *former* officer of Equity Funding, told Dirks about an accounting fraud.
- ❑ Dirks investigated, confirmed the fraud, passed the information on to his clients (who sold) and then told the SEC and the Wall St. Journal.
 - Bainbridge: “One might think that Dirks deserved a medal..., but one would be wrong.”
- ❑ The SEC censured Dirks for insider trading.

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- ❑ The US Supreme Court reversed the SEC’s decision.
 - Neither Dirks nor his customers had a fiduciary duty to Equity Funding.
- ❑ ... and offered a clarification
 - A tippee is liable only when they knew (or should have known) that their information was obtained through a breach of fiduciary duty by the original tipper.
 - A key element: did the tipper derive some sort of personal benefit in exchange for passing along the information?
 - ❑ Secrist did not.
 - ❑ What exactly is a “personal benefit”?
This becomes important in recent cases.

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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.
- ❑ When you use this information for profit, you might be violating some other fiduciary relationship.

Carpenter (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.
- ❑ Winans tipped off his roommate (David Carpenter).
- ❑ Carpenter tipped off Kenneth Felis (a stockbroker).
- ❑ The SEC alleged that Winans misappropriated the information in violation of a duty owed to his employer.
 - Convicted. Supreme Court split 4-4.
- ❑ Did Chiarella misappropriate information from *his* employer?

O'Hagan (1997)

- ❑ In 1988, Grand Metropolitan plans to take over Pillsbury.
- ❑ Grand Met retains the law firm of Dorsey & Whitney.
- ❑ James O'Hagan is a partner in the firm.
- ❑ He doesn't work on the takeover, but he learns about it, and buys Pillsbury shares.
- ❑ Charged with insider trading and convicted:
 - He misappropriated information from his employer (Dorsey & Whitney)
- ❑ Upheld by the US Supreme Court.

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The (Dirks) personal benefit

- ❑ 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 to derive benefit by receiving payment or other consideration.
- ❑ Is some payment (or other benefit) a *necessary* condition for alleging insider trading?

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Relationships and benefits: recent cases

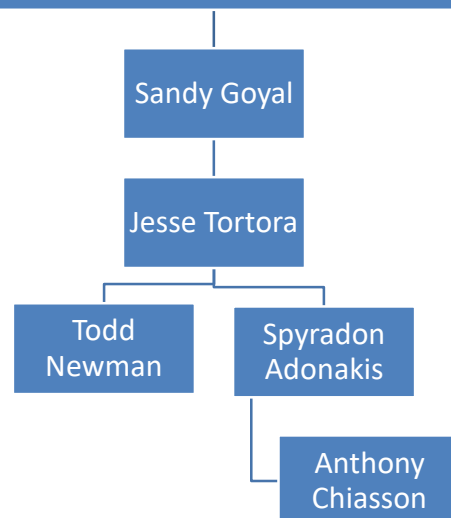
- Newman, Chiasson
 - Convicted; appealed; conviction overturned.
- Salman
 - Convicted; appealed; appeal denied.
- Martoma
 - Convicted; appealed; appeal denied.

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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
- Supreme Court refuses to review the case (October 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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Salman (2009)

- Maher Kara (Director, Investment Banking Division, Citigroup) shares information about a takeover with ...
 - His older brother, Michael Kara, who shares info with ...
 - His friend, Bassam Salman, who trades.
- Salman is convicted (September, 2011).
- Salman appeals: no personal benefit provided in exchange for the information.
- 2014: Newman conviction overturned by US Court of Appeals (2nd Circuit)
- 2015: Salman's appeal denied by US Court of Appeals (9th Circuit).
- Salman appeals to the Supreme Court, which agrees to hear the case.
- The decision in Salman (9th Circuit) appears inconsistent with Newman (2nd Circuit).
- Two lower courts come to different conclusions → Supreme Court decides.

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The Salman decision (US Supreme Court, December, 2016)

- ❑ "... A tipper breaches a fiduciary duty by making a gift of confidential information to 'a trading relative.'"
- ❑ "[G]iving a gift of trading information is the same thing as trading by the tipper followed by a gift of the proceeds."
- ❑ "Friends and family" tipping is illegal insider trading, even if no payment is between the tipper/tippee is involved.

Martoma (2014)

- ❑ Matthew Martoma specialized in healthcare stocks at SAC Capital (a large hedge fund).
- ❑ Martoma started a relationship with U. Michigan Professor Sidney Gilman who was monitoring a clinical trial for an Alzheimers drug.
- ❑ Martoma met with Gilman, and learned about negative results. SAC sold the stock of two companies working on the drug. Gilman presented negative results at a conference. The stock prices fell.

The arrest

On the evening of November 8, 2011, the Martomas returned home from running errands to discover two F.B.I. agents in their front yard. One of them, B. J. Kang, had been a key figure in the investigation of Steven Cohen. Kang has a buzz cut and a brusque demeanor, and he is known for carrying his service weapon—and several magazines of extra ammunition—with a regularity that may not be entirely necessary for an agent on the hedge-fund beat.

“Get inside the house,” he told Rosemary. “This has nothing to do with you.”

“I’m staying right here,” she replied. “Whatever you have to say to Mathew you can say to me.”

Kang turned to Martoma. “Do you want to tell her or should I?”

Martoma looked unsteady. Then he said, “You can go ahead and tell her if you like.”

Rosemary was confused and terrified. She had no idea what this was about.

According to Rosemary, Kang then said, “We know what you did at Harvard.” Martoma fainted.

Patrick Radden Keefe. *The empire of edge*. New Yorker (October 13, 2014)

The trial

- ❑ September, 2014. Martoma convicted.
- ❑ December, 2014: Newman conviction overturned.
- ❑ Martoma appeals
 - He and Gilman did not have a close personal relationship.
 - Gilman had not received any monetary or similar benefit.
- ❑ August, 2017: Appeal denied (conviction stands)
 - ... a corporate insider personally benefits whenever he discloses inside information as a gift with the expectation that the recipient would trade on the basis of such information or otherwise exploit it for his pecuniary gain.

The lesson (from Miller, Schacter, MacQueen)

[T]he Second Circuit clarified that *so long as someone gifts the inside information with the expectation that the tippee will trade, the nature of the relationship between the tipper and the tippee does not matter*. Thus, ..., the Second Circuit has provided additional gloss on the “gift theory” articulated in Dirks, holding that any gift suffices and focusing the relevant inquiry on whether a tipper expects that a tippee will trade on the inside information provided. Unless the panel’s decision in Martoma is overturned, the ambiguity and limitations created by Newman’s personal benefit test are all but gone and Martoma will significantly aid the government’s insider trading enforcement efforts.

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Dirks (1983, revisited 2017)

- Did Secrist (the tipper) expect Dirks (the tippee) to trade?

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The economics of insider trading regulation

- Readings
 - Bainbridge, An overview of insider trading law and policy, Part V, The Policy Debate, p. 24-28.
- Henry Manne (1966) *Insider trading and the stock market* argues against insider trading regulation.
 1. Insider trading makes markets more efficient (more private information gets incorporated into the security price)
 2. Insider trading is a good way to compensate managers.

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Efficiency

- Manne:
 - We want managers to produce information (to learn about the firm, its markets, its competitors, and so on).
 - This information can't always be publicized.
 - The stock price won't be accurate.
 - If managers can trade on the information, it will be impounded in the stock price.
- Bainbridge
 - We don't know if insider trading really would move the stock price to its "correct" value.
 - Most studies of insider trading examine insider trades reported to the SEC.
 - These "legal" insider trades can't be based on material nonpublic information.
 - The market has to infer the insider's trading activity from watching the order flow.
 - The adjustment process is rough and prone to errors.
 - Bainbridge: "derivatively informed trade"

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Compensation

- Manne
 - The best way of compensating entrepreneurs is to let them profit from the information that they produce.
 - Managers guide routine operations, and are best paid on salary.
 - Entrepreneurs produce valuable new information.
- Bainbridge
 - Why should insider trading result in the correct level of compensation?
 - What's the connection between insiders' profits and the value of the information produced?
 - Even if the price per share is "correct," the insiders' profits depend on the number of shares traded.
 - You can't restrict the information to entrepreneurs. Many employees will be involved in production and distribution of information.
 - If the information is negative, the manager can profit by selling short.
 - Does this give the manager an incentive for poor performance?

Some recent cases

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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Potential malpractice issues

The federal court ruling in *United States v Willis*¹² describes how a psychiatrist learned during treatment that a patient's husband was seeking to become CEO of a large bank. Realizing that this development might make the bank more valuable, the psychiatrist told his broker what he had learned and purchased 13,000 shares of the bank's stock for himself and his children. When the husband's efforts were announced publicly a few weeks later, the psychiatrist sold the shares at a big profit.

Quoting the vow of confidentiality contained in the Hippocratic Oath (*Box*),¹³ the court held that the psychiatrist had an obligation to the patient not to disclose information learned during her treatment without her permission. The court said the patient "had an economic interest in preserving the confidentiality of the information disclosed," and the psychiatrist's actions "might have jeopardized her husband's advancement" and financial benefits the wife would have gained. Also, the psychiatrist's "disclosures jeopardized the psychiatrist-patient relationship," which might negate the wife's financial investment in her care, require her to find a new psychiatrist, or require additional treatment to deal with how the psychiatrist's behavior had affected her.¹²

Clinical Point

A psychiatrist who uses information a patient discloses during treatment for financial gain could face legal consequences

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More legal consequences

Dr. Willis had legal problems more serious than just a malpractice lawsuit. He faced criminal prosecution for insider trading and mail fraud, and the court refused to dismiss these charges. The court reasoned that the psychiatrist received the information while in a position of trust and confidence, and breached that trust when he used that confidential information for his personal benefit—behavior that meets the legal definition of “misappropriation.” Because the psychiatrist received stock trade confirmations through the U.S. mail, he also could face federal charges of mail fraud. Ultimately, Dr. Willis pled guilty and paid \$137,000 in fines and penalties. Although Dr. Willis retained his New Jersey medical license and avoided a prison sentence, the district court sentenced him to 5 years of probation and required that he perform 3,000 hours of community service.^{14,15}

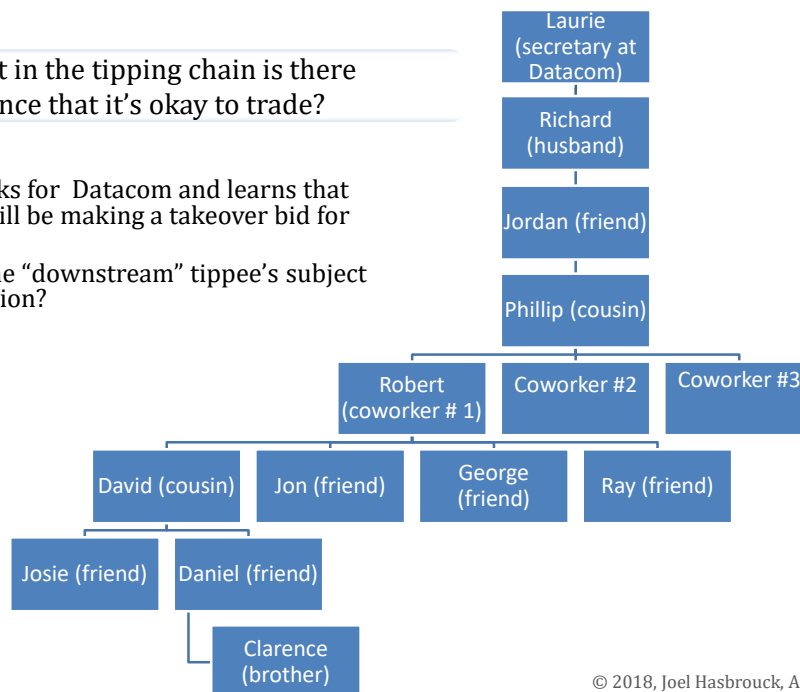
In a second case,¹⁶ a licensed clinical social worker made investments through a broker based on information learned during a therapy session about upcoming business developments (the 1994 Lockheed-Martin Marietta merger). The social worker pled guilty to insider trading, forfeited the illegal gains, and paid a large fine.

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At what point in the tipping chain is there enough distance that it's okay to trade?

- 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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