NYT, October 22, 2015

- U.S. Prosecutor to Drop Insider Trading Cases Against Seven
  - The impact of a landmark decision that made it harder to prosecute insider trading was amply demonstrated on Thursday as the top federal prosecutor in Manhattan moved to dismiss the charges and convictions of seven people.
  - The 2013 conviction of Michael S. Steinberg — the highest-ranking employee at SAC Capital Advisors to stand trial for insider trading — would be dropped, as would the guilty pleas of six cooperating witnesses.
  - The decision by Preet Bharara, the United States attorney in Manhattan, came just a little more than two weeks after the United States Supreme Court declined to review a ruling by the United States Court of Appeals for the Second Circuit that tossed out two other insider trading convictions and made it harder for authorities to pursue certain kinds of wrongful trading cases.
- [This caps a string of about 85 insider trading convictions since 2010.]
Chinese Manager of Highflying Funds Is Arrested in Insider Trading Case

- He has been called China's Carl Icahn. But the billionaire owner of one of the country's most successful investment firms is now the latest suspect in a broadening crackdown on corruption in the financial industry.
- The fund manager, Xu Xiang, nicknamed Big Xu, was apprehended in dramatic Hollywood fashion, more worthy of a spy movie than of a financier's arrest. As the police closed in, the highway patrol sealed off the 22-mile Hangzhou Bay Bridge for more than 30 minutes and eventually apprehended Mr. Xu near the exit late Sunday morning, according to state media.
- The government offered scant details on the arrest. "Xu Xiang and others are suspected of insider trading and other offenses and are in criminal detention," said a brief statement on the Xinhua News Agency, the government's official media outlet.

Outline

- "Legal" insider trading
- Illegal insider trading
  - Legal framework and principles
  - Economic arguments for and against.
- Readings (links on course web site)

Most of the material is from Bainbridge (2012), but you should read the following sections in Bainbridge (2001): II.B.2 (Cady, Roberts); II.B.3 (Texas Gulf Sulfur); III (Chiarella, Dirks); IV.B (the misappropriation theory); V.B.1 (Defining the fiduciary duty requirement); V.C (Who is an insider)

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.

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 basis for most of US insider trading laws is Rule 10b-5.
  - Insider trading is considered a “manipulative and deceptive” device under the rule.
- Most of the legal principles have been advanced by the SEC in specific cases and either affirmed or rejected in court rulings.
- This process is dynamic and political.
Key principles/aspects of the law

- Disclose or abstain
- Fiduciary duties (narrow)
- Tipping
- Misappropriation of information.
- Fiduciary duties (broad)

Disclose or abstain

- Anyone in possession of material non-public information must either disclose the information to their trading counterparty or abstain from trading.
- Consistent with fairness principle of “equal access to information”
- Emerged in a case known as Cady, Roberts (1961)
  - The board of the Curtis-Wright Corporation voted to reduce the dividend.
  - Cheever Cowdin was a director AND a partner at Cady, Roberts (a brokerage firm)
  - Cowdin told Robert Gintel (another partner); Gintel sold Curtis-Wright in customer accounts.
  - The cut is announced; the stock tanks; customers avoid losses.
  - SEC “articulated” the disclose or abstain rule and charged Gintel with insider trading.
  - Affirmed in an administrative ruling.
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.
- Does disclose or abstain apply to any informational advantage, however obtained?

The principle of fiduciary duty

- A “fiduciary relationship” a relationship of trust and confidentiality.
  - Vincent 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 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.
- In applying disclose or abstain, a duty to disclose only exists if there exists a fiduciary relationship.
Tipping

- In *Cady, Roberts*, the SEC charged Gintel (the *tippee*, the partner at the brokerage who received and acted upon the information)
  - He sold in *customer* accounts (acting on their behalf).
- In tipping cases, where is there a violation of a fiduciary duty?
- Tipping liability was refined in *Dirks*

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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 a 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.
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.

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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.
### Misappropriation: *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.
- He tipped off Carpenter (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?


- 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)
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?

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

MALPRACTICE RX
When your patients disclose ‘insider information’

Vol. 11, No. 12 / December 2012

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”

Douglas Mossman, MD
Dr. Mossman is Professor and Program Director, University of Cincinnati Forensic Psychiatry Fellowship, Cincinnati, OH
Potential malpractice issues

The federal court ruling in United States v Willis 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), 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.

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.

In a second case, 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.
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?

Litigation release

- SEC OBTAINS INJUNCTIONS AND OVER $580,000 IN DISGORGEMENT, INTEREST AND PENALTIES AGAINST INSIDER TRADERS IN LOTUS SECURITIES
- The Securities and Exchange Commission today announced ... disgorgement, interest and penalties totaling $581,117 in an insider trading case arising out of IBM's 1995 takeover of Lotus Development Corp.
- January 2, 2001
Rule 14e-3 (*new slide*)

- Adopted after Chiarella was decided (against the SEC), 1980.
- Applies to transactions in securities on the basis of material, nonpublic information *in the context of tender offers*.
- Prohibits insiders of target or bidder from trading on or revealing information about an actual or contemplated takeover bid.
- It is not necessary to establish breach of a fiduciary relationship or any kind of payment or benefit.

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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?
The case of the well-situated seller.

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

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?
The case of the rueful room mate

- “Amy” is an analyst for Cubic Investments-Pershing Square Investments (a hedge fund)
- “Amy” is working on a plan for Cubic Pershing to short-sell stock in GreenGrow Herbalife.
- Bianca Filip (“Amy’s” roommate) learns about the plan. “Amy” tells Bianca Filip that the information is confidential and that Bianca Filip shouldn’t trade on it.
- Bianca Filip tells her friend Caitlin Jordan about the plan. Caitlin Jordan buys put options on GreenGrow Herbalife.
- Insider trading? The SEC institutes cease-and-desist proceedings. Jordan has to return profits.

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?
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 ...

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.

Sandy Goyal

Jesse Tortora

Todd Newman

Spyradon Adonakis

Anthony Chiasson
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.

The economics of insider trading regulation (Bainbridge)

- Moving from “what is the law?” to “normative jurisprudence” (Bainbridge)
  - If the law were based on sound economic principles, what would the laws on insider trading look like?
- In *Cady, Roberts* (1961), the SEC articulated the principle of disclose or abstain.
- 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.
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.
    - Recall Ivan (“Private information and trading: the first pass”)

- **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”

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?

- **Other considerations**
  - Ownership. Isn’t new information the property of all the shareholders?
  - Stock bonuses and employee stock options.
“Insider trading is unfair.”

- What does “fairness” mean?
  - Equal access to information? This principle lies behind disclose-or-abstain, which the courts recognize as too limiting.
- One view (not Bainbridge): The insider didn’t produce the information – they just happened to be in the right place at the right time.
  - Valuable inside information is a windfall gain.

“Insider trading injures investors.”

- I sell stock to an insider. The insider knows (from private information) that the stock is worth $5 more. When the information is revealed, the stock price goes up by $5. I’ve lost $5 to the insider.
- Bainbridge:
  - You were going to sell anyway. You’d have lost from the sale to anyone; all purchasers have a gain (not just the insider).
  - The source of my “loss” comes from fact that the firm didn’t (perhaps couldn’t) share the information publicly.
Breach of fiduciary duty

- Bainbridge:
  - A breach doesn’t directly harm investors.
  - My loss isn’t affected by the source of the information or whether the purchaser was an insider.

Misappropriation of information

- Bainbridge:
  - This might be a matter for law, but it has no connection to investor protection.
  - R. Foster Winans allegedly misappropriated information from his employer (the Wall St. Journal).
    - Isn’t this an employee/employer matter?
  - Would it have been okay for the Wall St. Journal to trade on the information?

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“Insider trading hurts the issuer (the corporation that issued the stock).”

- 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.
  - In Texas Gulf Sulfur a geologist might have disclosed information before the firm had a chance to purchase all the mining rights.
Other reasons for regulation

- Inside information leads to trading costs for all investors.
  - Informational asymmetries increase the bid-ask spread.
  - In extreme cases, the market can fail entirely.
- Efficiency of enforcement
  - Companies can and do restrict trading by their employees.
    - “There’s no need for a law to prohibit something that could be handled by a contract. If stockholders didn’t want their managers to do insider trading, they could always put it in their employment contracts.”
  - But it is impossible for stockholders to monitor adherence to this contract.
  - A government agency with broad investigative powers is needed to detect insider trading.
  - It is more efficient to put insider trading regulation in the hands of the government rather than rely on private enforcement.

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.
Figure 1.3
Probability of trading against insiders from 1975 to 1995 by firm size

Figure 2.1
Net stock returns around insider trading
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;

**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.
Decoding inside information


- They separate 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.

- 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.