Debt-Equity Swaps in Latin America

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INSIDER TRADING: COULD LEGISLATION BE THE SOLUTION?

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"I'm about to tell you something I'm not supposed to tell anyone," says Harold, a former 1960s hippie and now successful manufacturer of running shoes. Harold is out running with a less-successful former college buddy and wants to help him. He reveals that his very small company will shortly be bought out by a large conglomerate. "Anyone who has our stock is going to triple their money," Harold continues. "By telling you this, I have just violated about sixteen regulations of the Securities (and) Exchange Commission, so don't repeat it."

— Scene from "The Big Chill" (as quoted in Dun's Business Month, June 1984).

Introduction

According to the Securities and Exchange Commission, Harold broke the law; but to most people insider trading differs from obvious crimes of violence or theft except in the sense that it is both illegal and unethical. Harold reminds us of the SEC's success in raising corporate consciousness about the illegality of insider trading, as well as its failure in changing the attitudes necessary to stop it. As former SEC attorney Harvey Pitt of Fried, Frank, Harris, Shriver, and Kampelman, puts it, "Insider trading is a way of life today. The problem is that people do not have any real fear" (Hershman, p. 49).

If most people feel this way, why not just make insider trading legal? The main reason given for keeping insider trading illegal is that it puts the average man on the street at a severe disadvantage. The theory is that in order to have an efficient stock market, one in which everyone operates with the same information, all trades must be based on public information that is available to any investor who wants it. The concept is better known as the "parity of information" theory, which holds that everyone should have an equal chance at acquiring the same information.

Insider trading is considered unacceptable conduct because by playing the market with nonpublic information, employers and clients are deceived, sellers of the target's stock who believe they are trading in a fair market are deceived, and exchange specialists and market makers can be financially ruined (Prentice, p. 62). It's much like a poker game played with marked cards. The person who owns the cards knows exactly what is going on — when to fold, when to bluff, and when to keep raising the
pot—while the rest of the players know only what is in their hands. This view holds that insider trading is cheating and it is wrong.

On the other hand, legalizing insider trading might make the market more efficient and more reflective of actual business dealings. Some experts argue that it would help get information out into the open much faster, all due to the fact that people would be more apt to trade on such information. Since the public would have more information, it would be able to trade and invest more efficiently.

The current state of the law has not been sufficient to deter people from trading on insider information, mainly because there is not a clear-cut definition of the crime. The SEC and Congress, to date, have been unwilling to define insider trading for fear of creating loopholes. Though at the time of this writing bills have been proposed which include such a definition, they are far from becoming law. Simple justice seems to demand that if the SEC and the courts are unable or unwilling to define the crime of insider trading, then prosecutors should stop bringing charges on that basis. This would remove the uncertainty in the current system.

The purpose of this article is to examine the current system of insider trading enforcement. The article will also discuss the arguments—pro and con—concerning the legalization of insider trading. While to most people legalizing insider trading may not be the best solution, the arguments brought to light should be seriously considered in helping to find a solution to the problem of enforcing the crime of insider trading.

Definition of Insider Trading—The Traditional View

Historically, the SEC has opposed the enactment of a statutory definition of the crime of insider trading for fear of giving defense attorneys opportunities to evade the law. Former SEC chairman J.R. Shad reiterated this position when discussing the Insider Trading Sanctions Act of 1984:

In order to reach unforeseen fact patterns, any definition would have to be very broad. The flexibility which is gained by basing the imposition of the (penalty) on existing case law avoids the problem of freezing into law either a definition which is too broad, or too narrow to deal with newly emerging issues (Tidwell, p. 93).

Traditionally, the courts have held that insider trading is the trading of securities while in possession of material non-public information in violation of a fiduciary duty. This duty requires loyalty to the shareholders. If the accused is found not to have any such relationship to the shareholders with whom he deals, he will not be convicted of insider trading. This fiduciary duty was at the core of the traditional view. However, as will be discussed below, this view is changing.

Congress had the opportunity to define insider trading with the Insider Trading Sanctions Act. Instead it followed Shad's advice and left the defining to the judiciary. However, despite this reluctance to define the crime, the SEC still emphasizes that this is a "prime area of concern and a principal target of its enforcement activities" (Farley, p. 1771).

Robert A. Prentice explains Congress' opposition to insider trading by claiming that statements in the House Report of the Insider Trading Sanctions Act implied that Congress is against insider trading, including that done by outsiders. Outsiders are those who do not have a direct duty to the shareholders. As Prentice goes on to say:

Such statements, coupled with the facts that Congress (1) greatly increased the sanctions for insider trading, (2) ignored calls for specific definitional legislation, and (3) had knowledge that the lower courts had expanded the scope of the ban on inside trading to include many categories of outsiders, indicate that, at the very least, Congress has no strong objection to this extension (Prentice, p. 58).

The extension of which he speaks involves the fact that the courts have begun to expand the notion of insider trading to include outsiders. No longer is it necessary to have a fiduciary duty to the shareholders in order to be convicted of insider trading.
As was mentioned above, the bulk of current insider-trading law has been created by court case precedents. For example, though the liability of insiders has not changed substantially, the potential liability of outsiders has greatly increased as a result of such key cases as Dirks, Chiarella, Newman, and Lund. However, this liability depends both on how and from whom the information was obtained, as illustrated by the following:

An outsider who trades on inside information obtained from an insider who breached a fiduciary duty in disclosing it, has tippee liability under Dirks. An outsider who trades on insider information obtained from an insider who disclosed the information for a legitimate commercial reason obtains Lund temporary insider status and its attendant liabilities, if the disclosure carried an expectation of confidentiality. An outsider who misappropriates or steals inside information, rather than receiving it from an insider, is also liable (at least criminally and in an SEC injunctive action) under Newman. Only the outsider who obtains the information by his own legitimate devices such as an investment adviser who does his homework is clearly not liable (Pretice, p. 57).

For clarification purposes, the following examples are provided to illustrate each of the above cases:

- If the CEO of Acme, Inc. tells Joe, his best friend, of a proposed merger with another company, Joe will have tippee liability under Dirks if he trades on this information. Simply stated, if one receives a tip and has reason to believe the information is material nonpublic information, and if he subsequently trades on it, that person can be held liable.
- If Joe, a professional accountant, receives the same information when consulting with Acme, Inc. about a related project, Joe assumes temporary insider status and would be liable under Lund.
- If, while waiting inside the office of the CEO of Acme, Inc., Joe looks through notes on his desk, finds information regarding the merger, and subsequently trades on it, he will be liable under Newman.

The above examples may still give a false sense of certainty, however; for the courts are still not of one mind with respect to the circumstances under which individuals might be held liable. This, of course, is part and parcel of our judicial system: its ability to constantly adapt a law to changing circumstances. However, how can corporate insiders and outsiders be expected to take seriously a crime that Congress and the SEC have been afraid to define? "No one is dragged into court on a charge of insider trading; instead they are charged with securities fraud. The securities laws do not explicitly say what is and what is not insider trading. People can not be sure whether they are committing a crime or just being astute" (Frank, p. 80).

If insider trading is to be considered illegal, then something more than a hodgepodge of "hypotheticals" developed from case law is needed. The public deserves more specific insider trading legislation so as to be able to understand what is and is not permissible.

**Arguments in Favor of Insider-Trading Laws**

It is true that the majority of people believe insider trading should remain illegal. For instance, as Democratic Congressman Timothy Wirth of Colorado says, "Insider trading threatens these markets by undermining the public's expectations of honest and fair securities markets, where all participants play by the same rules" (Hershman, p. 50). And as Democratic Senator William Proxmire of Wisconsin says of insider trading, "I can't think of anything more destructive of confidence in the markets" (Hershman, p. 50).

What is said and implied is that insider trading is an area of serious concern, and that both the SEC and Congress believe that something must be done about it. At the current time, Congress and the SEC are finally taking some positive steps toward cracking down. Dur-
ing the latter half of 1987, proposals for a new insider trading law surfaced — proposals which include a specific definition of the crime. Both the Senate and the SEC have submitted proposals to Congress. The proposals are nearly identical, except for some minor differences. Under the SEC’s proposal a person is engaged in illegal insider trading if he “knows or recklessly disregards that such information has been obtained wrongfully or that such purchase or sale would constitute a wrongful use of such information” (Robb, p. 34). “Wrongfully obtained” is defined as having been obtained via “theft, bribery, misrepresentation, electronic espionage” or through a “breach of any fiduciary, contractual, employment, personal or other relationship” (Robb, p. 34).

The above does not in any sense constitute a revision of SEC thinking. This proposal simply makes what is currently a matter of unclear case law into well-defined securities law. As the SEC has described the purpose of its proposal, “The proposed legislative definition of insider trading is intended to distinguish wrongful chicanery from legitimate competition and to preclude foul play while protecting fair play” (Sterngold, p. D8). This definition appears to do just that.

If the above definition is accepted, there should no longer be any doubt as to what constitutes insider trading. People would no longer have to operate in a cloud of confusion. Furthermore, it is a definition that, if passed, should lead to more convictions, especially in cases where the evidence is present but the current law is vague. This new definition, though, will not necessarily increase the percentage of violators who are apprehended. It is common knowledge that insider trading is so widespread that only a small percentage of wrongdoers are ever detected (Prentice, p. 61). What is required is not only a clear definition of the crime, but an improved detection system as well.

The fact remains that many people will probably continue to trade on inside information even with new legislation. The only way things will change is with an improved detection system; improved regulation is not going to be sufficient. One observer, Attorney Harvey Pitt, has said that he would be surprised if the SEC is currently catching more than twenty percent of the cases (Hershman, p. 55). The computers only send off an alarm when there is a significantly high volume of stock traded or when a stock’s price moves up and down at an unusually rapid pace. The New York Stock Exchange’s Stock Watch computers, which monitor all New York Stock Exchange-traded stocks, flag hundreds of trades each day as being of the “unusual” variety. The Stock Watch Department attempts to investigate these transactions, but usually ends up eliminating virtually all of them from suspicion, for whatever reason. In cases where the Department does believe that an unusual trade has come about because of trading on insider information, it notifies the SEC (Cleeton). Usually, though, it will only be the “greedy” ones who are caught.

Prentice has argued that the increased sanctions brought about by the Insider Trading Sanctions Act of 1984 may well increase deterrence, but that no one expects the problem to disappear. “More deterrence, not less,” he claims, “is needed” (Prentice, p. 61). At the time of this writing, however, insider trading seems to have grown substantially since Prentice’s article was written (1985). But what form of greater deterrence is needed if, as Prentice stated, “only a small percentage of (insider trading) is ever detected?” (Prentice, p. 61). If having to return triple one’s ill-gotten gains — as the penalties laid down in the Act require — is not sufficiently deterring, then perhaps extended prison sentences for such crimes should be considered. The proposed regulation’s main purpose is to (at last) define insider trading; but that, by itself, will not rid the system of the problem. Because of the SEC’s flawed detection system, it will only succeed in catching those who are not satisfied with only modest gains. The thinking seems to be that if one simply covers his tracks carefully, there is nothing to worry about.

The proposed legislation is probably very nearly what is needed to secure insider trading convictions. However, as mentioned before, the system of detection — therefore enforcement — could be improved greatly. But, to devise a more sensitive detection system similar
to what the stock exchanges now have and to still be able to distinguish between fair and foul play may be an insurmountable task.

**Arguments Against Insider-Trading Laws**

Some legal scholars and market academicians, rather than applauding the SEC for its investigative skill, have proposed that insider trading be made legal. By removing the restrictions, they say, insiders would act more quickly, and such information would flow rapidly into the marketplace. That, in turn, would put the public on a more equal footing with insiders. “Insider trading would not only make the markets fairer, but also more efficient,” says Stephen Figlewski, Professor of Finance at New York University's School of Business. He adds, “There are always going to be people who have information that the average guy does not have. The idea is to get it into the open faster” (Frank, p. 81).

Most people would counter with the argument that legalizing insider trading would frighten the average investor away, leaving the trading to corporations and market-wise “big-wigs.” However, insider trading is so widespread at this time, with only a small fraction of violators ever caught, that many potential investors may already be wary of participating. Also, it must be said that many small investors who do play the market tend to buy their stocks and hold for the long-term. Because of this, such investors are probably less likely to be affected by short-term shocks resulting from trading on inside information. But with the legalization of insider trading, the average investor could then ask his “friendly neighborhood corporate executive” for a tip without either of them having to worry about the authorities. This might, in turn, prompt many more potential investors to look to the market. After all, information is the “raw material for the securities business, and those who find it first and use it best will reap the benefits” (Frank, p. 88).

One observer, John Boland, believes that current regulation has strayed somewhat from its purpose of investor protection. He comments that the proposed legislation now in Congress would insist on “inequality.” As Boland states:

> If the rationale for regulation is specious, the argument that investors benefit from the SEC’s specific rules has even less merit. The business of regulating the flow of information to the stock market is the business of keeping secrets from the market. If people possessing material information are barred from using it in the market, prices will less accurately reflect business realities. An investor or pension fund that sells Republic Air into a market where the buyout is being whispered gets a better deal than if Northwest’s plans are known only to Northwest (Boland).

Yet, according to the SEC, keeping information and participants on the sidelines improves the market’s efficiency and integrity, and keeping investors in the dark protects them. It is not clear why the SEC holds this view. According to Boland, the SEC seems to believe that the brokerage house trader who sees the first public word over a newswire (a privilege only because of his vocation) is more entitled to profit from such a development than a short order cook in Des Moines whose brother works at Northwest. The SEC’s main purpose does not seem to be either investor protection or an efficient market, but narrower “regulatory muscle, staff, and budget” (Boland). This simply means that the SEC is often seen as more concerned with increasing its power and control over those who engage in illegal trading as opposed to paying attention to what would really help the market and its participants.

Another reason which is sometimes offered for legalizing insider trading involves the suggestion of an alternative method of deterrence. Very few individuals or financial institutions like the idea of expending substantial sums in defense costs in the investigative, trial, and appeal stages of an action where success is defined simply as a ruling saying that their conduct was not illegal, though perhaps unethical, reprehensible, and otherwise disreputable. The possibility of the latter determination in itself serves as a sufficient deterrent for most institutions and results in voluntary in-
ternal prohibitions against such conduct by employees regardless of legal fine points (Farley, p. 1780). In fact most firms would rather deal with insider trading violations internally, without government intervention, regardless of the state of insider trading's legality. According to this line of thinking, methods of deterrence, as well as punishment, should be left to the corporations. By legalizing insider trading and leaving the "police work" to the employers, the market could then become more efficient. Each company could regulate the type of information that it wished to release. If an employee violated this policy, the company could then deal with him/her as it pleased. Matthew Farley is a strong supporter of this idea. He contends that "court action is unnecessary because there are sufficient remedies available to any employer to deal with employee misbehavior without using such an event as an illogical linchpin of a securities law violation" (Farley, p. 1782).

Farley argues further that certain anomalies exist in the market, one of which is that "the employee who overhears the acquisition plans of high executives and then trades may be a misappropriator, but a nonemployee on the same facts is arguably not so labeled or so restricted" (Farley, p. 1781). Other would say that the "integrity of the marketplace" is not injured quite so much by someone taking advantage of material nonpublic information accidentally overheard as it is by an intentional, fraudulent misappropriation (Prentice, p. 67). Whether the latter statement is true or not is difficult to say. In either case, the person is trading on information which is confidential. Strictly speaking, therefore, both trades are illegal. The marketplace does not "see" who trades, but rather only what they trade and the consequent effect on the stock's price.

In the opinion of many, investor confidence in the securities markets does not depend upon an absolute parity of information, but only upon the lack of significant fraudulent conduct (Prentice, p. 67). Insider trading could be made legal, efficiency could be increased, and the market could be totally free of fraudulent conduct; but the average investor still would not have access to all the information that brokers have. This being the case, investors may still be intimidated because they know others have significant information to which they simply do not have access. This will always remain a problem, regardless of the legal status of insider trading.

Conclusion

Insider trading is illegal. Yet, it is—and will probably remain—a crime with an extremely low detection rate. What is the public to do? Stronger sanctions have failed. To date, the SEC and Congress have refused to pass legislation offering a precise definition of the crime. But even if such legislation is passed, it is doubtful that people will be deterred by it. Also, many small investors today are reluctant to invest, not knowing what others know. Since insider trading seems rampant right now, making insider trading legal might not make a difference to the small investor, especially when the SEC is only able to catch the Chiarellas, the Dirks, and the Winans—only a small fraction of the total number of suspected violators. Insider trading is everywhere, and the small investor knows it. Public confidence, therefore, will not be restored through invoking tougher penalties, but only through improved detection and enforcement.

As this writer sees it, in order to be fair to the average investor and to keep insider trading illegal, the only apparent option the SEC has is an improved detection system. But since that seems almost impossible to effect, perhaps it should consider legalizing insider trading. This would make it the responsibility of employers to make their own codes of ethics, including reprimands should these codes be broken.
REFERENCES


