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The Prohibition On Insider Trading Is Misleading

By **Kevin Douglas** (October 11, 2023, 1:52 PM EDT)

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Most Americans support high-profile convictions for insider trading, i.e., benefiting from stock trades based on certain kinds of nonpublic information.

Some courts have even compared insider trading to embezzlement and described defendants as stealing a company's trade secrets when making illegal trades.[1]

With the popularity of punishing insider trading,[2] it is not surprising that officials regularly tout enforcement actions and prosecutions.

At the end of September, the U.S. Securities and Exchange Commission charged a former Goldman Sachs analyst and three of his friends with insider trading for buying stock in target companies ahead of merger announcements.

In February, the U.S. Department of Justice celebrated the first criminal conviction for insider trading with crypto-assets in U.S. v. Wahi.[4]

And last December, the SEC increased restrictions on executive trading plans[3] to close what many called loopholes used as get-out-of-jail-free cards.

Unfortunately, insider trading law is misleading. Officials describe the law as protecting the property rights shareholders and publicly traded companies have in inside information.

In practice, however, these laws criminalize having economic advantages that allow a person to accurately predict changes in stock price.[5] Simultaneously, these laws redefine "fairness" and "fraud" in ways that undermine the protection of property rights.[6]

To understand these concerns, first consider normal trading activity.

Investors buy stock in a company to make money — to sell that stock for more than they paid. This process generally involves active investors believing they know something others do not. This knowledge may be derived from suggestions, advice, tips, hints and even copying successful traders — many trades are based on some kind of insider knowledge.

Some people simply have greater access to profitable information. Is this access a form of privilege? Definitely.

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The average person cannot simply stroll into a public company board meeting ahead of quarterly disclosures and buy or sell stock based on what they learn there. Still, some people do know about profits, losses, struggles, scandals and brilliant breakthroughs before the rest of the world. And those people do tend to be wealthy, well-connected or both.

What makes that kind of access "unfair"?

Morally, having friends or family members with access to information that will give you an advantage when trading in stock markets is hardly different from having friends or family members who are plumbers when you need to remodel your house. Benefiting from relationships that get you a discount on kitchen and bathroom fixtures will not land you in jail. Neither should benefiting from relationships that get you advanced information on stock price movement.

What about a company's or the shareholders' property rights in inside information? If we send people to jail for trade secret misappropriation, why shouldn't we send people to jail for insider trading?

This is where insider trading law gets tricky. In most other trades and professions, trade secret owners can consent to someone else using their information. Yet, most insider trading regulations prevent companies and other information owners from agreeing to others trading on their information.[7]

The prohibition on insider trading is a ban on consensual exchange.

Sure, many voters support straightforward economic regulations, like minimum wage laws. But voters are told that insider trading laws protect public companies and shareholders from theft;[8] instead, these laws criminalize certain kinds of economic inequality. And unlike using taxes to redistribute wealth, which is arguably effective at reducing inequality, the prohibition on insider trading is just a form of wealth nullification. No one benefits.

These and other issues make insider trading laws fundamentally unjust in at least one way.[9] The law explicitly treats different kinds of individuals unequally.

Like it or not, C-suite executives exist, and they have friends and families and money managers and business associates. Barring these people from sharing their professional knowledge and connections with family and friends is more than arbitrary. No one would suggest that we prohibit plumbers, doctors or lawyers from sharing their professional knowledge or relationships with neighbors or family members. And no one should.

Now let's return to the other justification officials rely on to criminalize insider trading activity: Officials claim that insider trading law protects members of the investing public from trading with people who have unfair information advantages.

What can it mean to need protection from a stranger's misuse of accurate information?

Let's momentarily ignore the possibility that officials are trying to protect less knowledgeable investors from information inequality. There are at least two other reasons to think investors need protection from true information. One is demeaning, and the other is unrealistic.

The demeaning possibility is that officials think of securities markets as similar to casinos, and view all

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investors and finance professionals as gamblers.

Sure, many investors are just shooting blindly and hoping to hit the mark. Nevertheless, the best investors and finance professionals are like investigative journalists who earn a living by trading stocks based on their discoveries instead of by writing an exposé.[10]

The unrealistic possibility is that insider trading law is based on the idea that prices can be incorrect, and that knowingly trading at the purportedly wrong price is a form of fraud.

Because of their belief in correct prices, officials treat the prohibition on insider trading like a reverse lemon law. Instead of punishing a person for selling something with a major undisclosed product defect, insider trading laws punish people for selling something with an undisclosed price defect.

Lemon laws make sense if we recognize free trade as fair trade. Transactions are at least ethically defensible — and often ethically praiseworthy — when all parties get the right kind of consent. But if a seller hides an important flaw — like a crack in a car engine — it undermines the validity of a buyer's consent. At the same time, this principle makes the "right" price the price agreed to by the buyer and seller.

Of course, many take for granted that correct prices exist, and a lot of ink has been spilled in arguing over how to "find" correct prices.

Some argue that prices are correct when they reflect all available product information. Others describe prices as correct when they approach the average or market price. Some laws even require fiduciaries — i.e., directors — to trade at market prices and obtain informed consent ahead of transactions with their principals, i.e., stockholders.

Let's say that correct prices exist. Is the belief in correct prices enough to justify barring public companies and their stockholders from consenting to insider trading?

If trading at the wrong price implies losing money, shouldn't we differentiate between investors being robbed and investors volunteering to give something away?

Even the increasingly popular environmental, social and governance movement encourages corporations to make larger charitable donations — essentially using shareholders' money — and to pay more for electricity to subsidize carbon capture or solar energy sources. And the SEC is encouraging this movement.[11]

Some argue that allowing insider trading would encourage corporate directors and officers to mismanage company assets in order to enrich themselves at the expense of shareholders.

This surprisingly popular argument could apply to any activity, and it undermines our legal commitment to the presumption of innocence. If we should prohibit insider trading because CEOs might time disclosures in a way that injures shareholders, then shouldn't we prohibit the sale of knives because chefs might stab innocent restaurant patrons?

Others argue that the average shareholder does not know enough to consent to a practice like insider trading. If adults are competent enough to vote for the president of the U.S. or to choose their own lawyers when on trial for securities fraud, how are we not competent enough to consent to trading at

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the ostensibly wrong price?

The popularity of this argument makes it clear that respect for the rule of law requires a presumption of competence in addition to the presumption of innocence.

More importantly, what we think of as correct prices do not exist. Investors can be correct, or not, in their prediction of price movement, but prices can only be consensual, or not.

Given all of this, the prohibition on insider trading should be rejected. Lawmakers and SEC officials should protect all consensual trading.

This means that boards of directors should be free to license trading on inside information as a form of consideration when dealing with employees or third parties.

Or, shareholders should be allowed to amend their articles and certificates of incorporation to allow insiders to benefit from trading opportunities based on inside information.[12]

Officials should also pardon those previously punished under the prohibition.

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[1] See United States v. O'Hagan, 521 U.S. 642, 653-654 (1997) ("The undisclosed misappropriation of such information, in violation of a fiduciary duty, the Court said in Carpenter, constitutes fraud akin to embezzlement—'''the fraudulent appropriation to one's own use of the money or goods entrusted to one's care by another.' '').

[2] John P. Anderson, Jeremy L. Kidd & George A. Mocsary, Public Perceptions of Insider Trading, 51 Seton HALL L. REV. 1035 (2021).

[3] https://www.sec.gov/news/press-release/2022-222.

[4] https://www.justice.gov/usao-sdny/pr/former-coinbase-insider-pleads-guilty-first-ever-cryptocurrency-insider-trading-case.

[5] For a more detailed explanation, see this authors recent article in the Journal of Corporation Law, How Fatal Ambiguity Undermines Effective Insider Trading Reform, <https://jcl.law.uiowa.edu/articles/2023/03/how-fatal-ambiguity-undermines-effective-insider-trading-reform>; ; especially part III.B. of that article.

[6] Chiarella v. United States, 445 U.S. 222, 227 (1980) (Declaring that an insider's obligation to disclose all material information or abstain from trading "arose from (i) the existence of a relationship affording access to inside information intended to be available only for a corporate purpose, and (ii) the unfairness of allowing a corporate insider to take advantage of that information by trading without disclosure."). The conception of fairness used in insider trading cases requires disclosure to the general

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public and not (1) the informed consent of a principal or (2) disclosure to only a person's fellow principal-fiduciaries (partners, shareholders, etc.). This conflicts with the conception of fairness used in other duty of loyalty cases, which only require fiduciaries to obtain the right kind of consent and to trade at market prices. See the entire fairness test described in Weinberger v. UOP, Inc., 457 A.2d 701, 711 (Del. 1983).

[7] In the 2000, the SEC adopted of Regulation FD, which prohibits public companies from selectively disclosing inside information, which would be necessary to license trading on that information. See 17 C.F.R. § 243.100-103 (2021). In the 1980s, the SEC adopted Rule 14e-3, which makes it difficult for parties staging tender offers to license trading on that information. See Chiarella v. United States, 445 U.S. 222, 234 (1980).

[8] See page 3 of PREET BHARARA ET AL., REPORT OF THE BHARARA TASK FORCE ON INSIDER TRADING (Jan. 2020), https://www.bhararataskforce.com/s/Report-of-the-Bharara-Task-Force-on-Insider-Trading.pdf. See also Final Rule: Insider Trading Arrangements and Related Disclosures (sec.gov); and page 174 of the recent rule change to 10b5-1 trading plans. The SEC release states that the new rule will "help investors better understand how issuers protect their confidential information—which "qualifies as property to which the company has a right of exclusive use"—as well as guard against the misappropriation of that information." Citing United States v. O'Hagan, 521 U.S. 642, 654 (1997).

[9] For this author's take on what makes the current law unjust, see Part IV.B. of How Fatal Ambiguity Undermines Effective Insider Trading Reform, <https://jcl.law.uiowa.edu/articles/2023/03/how-fatal-ambiguity-undermines-effective-insider-trading-reform>;.

[10] See Dirks v. SEC, 103 s.ct. 3255 (1983).

[11] Press Release, SEC Proposes Rules to Enhance and Standardize Climate-Related Disclosures for Investors, https://www.sec.gov/news/press-release/2022-46

[12] Section 8.70(a)(2) of the Model Business Corporation Act allows directors to limit or eliminate the requirement that insiders offer business opportunities to the corporation before taking advantage of the opportunity.264 Section 122(17) of the Delaware General Corporation Law similarly allows a provision in the certificate of incorporation to renounce "specified classes or categories of business opportunities that are presented to the corporation or 1 or more of its officers, directors or stockholders.

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