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Timothy Reeb

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SHOULD WE LEARN TO LOVE INSIDER TRADING?

by TIMOTHY REEB

The American notion that insider trading should be punished civilly was established over one hundred years ago.¹ In 1934, a federal statute made insider trading punishable criminally, and ever since United States enforcement agencies have considered insider trading violations a top priority.²

Despite the traditional American stance, many countries do not punish insider trading.³ Even in the United States, some scholars believe that insider trading can have a positive impact on financial markets.⁴ For example, Donald Boudreaux, Economics Professor at George Mason University, has outlined reasons for not only de-criminalizing, but also encouraging insider trading.⁵

In his article, Boudreaux explains that when insiders buy or sell stock based on inside information, the price of the stock quickly changes.⁶ The positive result,

according to Boudreaux, is stock prices that accurately reflect corporate realities.⁷

While consistent with the views of at least two leading economists,⁸ Boudreaux's stance has received scholarly criticism and is in sharp contrast to that of the U.S. Securities & Exchange Commission (SEC) and the U.S. Department of Justice (DOJ).⁹ University of California Los Angeles Law Professor Stephen Bainbridge, for example, specifically dismisses Boudreaux's approach. Bainbridge argues that insider trading affects prices much more slowly than Boudreaux suggests.¹⁰

Boudreaux's views appear irreconcilable with those of scholars such as Bainbridge. However, the two professor's contrasting stances highlight the reality that American views on insider trading may not be as clearly defined as history suggests.

INSIDER TRADING LAWS: AN AMERICAN TRADITION

According to the SEC, illegal insider trading "refers generally to buying or selling a security, in breach of a fiduciary duty or other relationship of trust and confidence, while in possession of material, nonpublic information about that security."¹¹

In a 1998 speech, Thomas C. Newkirk, then Associate Director of the SEC's Enforcement Division, described the history of insider trading laws in the United States.¹² "The American notion that insider trading is wrong goes back over one hundred years."¹³ Newkirk explained that insider trading was criminalized in the United States after the stock market crash of 1929.¹⁴

"In response to the crash, Congress enacted the Securities Act of 1933 and the Securities Exchange Act of 1934, aimed at controlling the abuses believed to have contributed to the crash. The 1934 Act addressed insider trading directly through Section 16(b) and indirectly through Section 10(b)."¹⁵ According to Newkirk, "ever since [the enactment of the 1934 Act], courts and regulators [have] struggled to refine prohibitions on insider trading."¹⁶

The 1934 Act also grants the SEC the power to enforce civil violations of insider trading laws and grants the DOJ the authority to seek criminal sanc-

tions.¹⁷ Linda Chatman Thomsen, Director of the SEC's Division of Enforcement, described the SEC's approach to insider trading violations over the past 80 years during her September 2006 testimony before the U.S. Senate Committee on the Judiciary.¹⁸ "The Division pursues these cases day in and day out and has developed unparalleled expertise in this area," Thomsen explained.¹⁹

"Indeed, a long list of prominent and not so prominent individuals would undoubtedly testify that the Enforcement Division does not pull its punches," Thomsen continued.²⁰ "The respective histories of the SEC and DOJ, as well as those of state attorneys general and securities regulators, demonstrate our collective commitment to prosecuting insider trading, civilly and criminally, under federal and state law."²¹

LOVE IT?

Despite the SEC and DOJ's strong stance against insider trading violations, not all Americans share the same sentiment. In his October 2009 article, "Learning to Love Insider Trading," Boudreaux lays out his argument in favor of insider trading.²² "Time to stop telling horror stories," Boudreaux begins.²³ "Insider trading is impossible to police and helpful to markets and investors."²⁴

The cornerstone of Boudreaux's argument revolves around the efficiency of market prices: "Prohibitions on insider trading prevent the market from adjusting as quickly as possible to changes in the demand for, and supply of, corporate assets."²⁵ "The result," Boudreaux explains, "is prices that lie."²⁶

On a subsequent television appearance on CNBC's "Kudlow Report," Boudreaux discussed his position further.²⁷ "If insiders can trade on non-proprietary information, they drive those prices more quickly to their correct levels," he explained.²⁸ "And that means that the millions of stock traders out there, who are not insiders, are able to buy and sell at prices that more closely reflect their true values."²⁹

Boudreaux is not alone in his stance. Henry Mann, Dean Emeritus at George Mason University School of Law, has argued forcefully against the criminalization of insider trading.³⁰ In addition, Milton Friedman, American economist and Nobel Prize laureate, said in a 2003 interview, "You want more insider

dealing, not less; you want to give people most likely to have knowledge about deficiencies of the company an incentive to make the public aware of that.”³¹

OR HATE IT?

Other scholars disagree with the suggestion that insider trading should be decriminalized.³² Specifically, Bainbridge addresses Boudreaux’s stance, stating that “insider trading simply does not have the effects Boudreaux ascribes to it.”³³ “If insider trading is to affect the price of securities,” Bainbridge begins, “it is through the derivatively informed trading mechanism of market efficiency.”³⁴ Bainbridge explains that when those individuals possessing material nonpublic information begin trading, their trading has only a small effect on price.³⁵ He believes that, after the insider trading occurs, some uninformed traders become aware of the insider trading and react to that information.³⁶ Finally, according to Bainbridge, “the market reacts to the insiders’ trades and gradually moves towards the correct price.”³⁷

“Given the inefficiency of [insider trading],” Bainbridge concludes, “the market efficiency justification for insider trading loses much of its force.”³⁸

Loyola University Chicago School of Law Professor Steven Ramirez agrees with Bainbridge.³⁹ “Boudreaux is in really weak territory here,” Ramirez begins.⁴⁰ “If you take out the insider trading laws, investors will lose confidence and that could take out 15 percent of the equity in our financial markets on a permanent basis.”⁴¹

NOT SO CLEAR AFTER ALL

Boudreaux and Bainbridge pose viewpoints that appear irreconcilable: Boudreaux argues insider trading quickly adjusts the price of stocks⁴² while Bainbridge argues it does so very slowly.⁴³ Perhaps, however, the mere fact that such differing viewpoints exist is noteworthy. Considering the United States’ long tradition of punishing insider trading, Boudreaux and Bainbridge highlight the reality that American views on the topic may not be as clear cut as history suggests.

NOTES

- 1 Testimony of Linda Chatman Thomsen, Director of Enforcement U.S. Securities & Exchange Commission, before the U.S. Senate Committee on the Judiciary (Oct. 5, 2006), *available at* <http://www.sec.gov/news/testimony/2006/ts092606lct.htm>.
- 2 *Id.*
- 3 Speech delivered by Thomas C. Newkirk, Associate Director, SEC Division of Enforcement, 16th International Symposium on Economic Crime, Cambridge, England (Sept. 19, 1998), *available at* <http://www.sec.gov/news/speech/speecharchive/1998/spch221.htm>.
- 4 *Id.*
- 5 Donald J. Boudreaux, *Learning to Love Insider Trading*, WALL ST. J., Oct. 24, 2009, *available at* <http://online.wsj.com/article/SB10001424052748704224004574489324091790350.html>.
- 6 *Id.*
- 7 *Id.*
- 8 Jonathan Fisher, *Stock Market Investing: Is Insider Trading Such a Bad Thing?*, TELEGRAPH.CO.UK, June 10, 2009, *available at* <http://www.telegraph.co.uk/finance/personalfinance/investing/5492729/Stock-market-investing-Is-insider-trading-such-a-bad-thing.html>.
- 9 Stephen Bainbridge, *Learning to Love Insider Trading? Let's Not*, Oct. 24, 2009, *available at* www.professorbainbridge.com/professorbainbridgecom/2009/10/learning-to-love-insider-trading-lets-not.html.
- 10 *Id.*
- 11 *Spotlight on Insider Trading*, U.S. Securities & Exchange Commission, *available at* <http://www.sec.gov/spotlight/insidertrading.shtml>.
- 12 Newkirk, *supra* note 3.
- 13 *Id.*
- 14 *Id.*
- 15 *Id.*
- 16 *Id.*
- 17 Newkirk, *supra* note 3.
- 18 Thomsen, *supra* note 1.
- 19 *Id.*
- 20 *Id.*
- 21 *Id.*
- 22 Boudreaux, *supra* note 5.
- 23 *Id.*
- 24 *Id.*
- 25 *Id.*
- 26 *Id.*
- 27 CNBC's Kudlow Report, Nov. 5, 2009, at 46 minutes, *available at* <http://www.cnbc.com/id/15840232?video=1320696993&play=1>.
- 28 *Id.*
- 29 *Id.*
- 30 Boudreaux, *supra* note 5.
- 31 Fisher, *supra* note 8.
- 32 Bainbridge, *supra* note 9.
- 33 *Id.*
- 34 *Id.*
- 35 *Id.*

36 *Id.*

37 *Id.*

38 Bainbridge, *supra* note 9.

39 Telephone Interview with Steven Ramirez, Professor, Loyola University Chicago School of Law, in Chi., Ill. (Feb. 24, 2010).

40 *Id.*

41 *Id.*

42 Boudreaux, *supra* note 5.

43 Bainbridge, *supra* note 9.