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Prioritizing Enforcement in Insider Trading

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INTRODUCTION

Enforcement of insider-trading regulations is currently a high priority for the Securities and Exchange Commission (SEC). This is unsurprising, as the SEC tends to enforce insider-trading laws more vigorously when markets are volatile.[1] But where should the SEC focus its investigations? This Comment argues that the SEC should concentrate on enforcing insider-trading regulations most vigorously against individuals who are not employees or directors of the corporation whose shares are being traded. In contrast, the SEC should regard as a lower priority the enforcement of insider-trading regulations against that corporation's employees and directors. Companies are capable of taking various forms of action against their own employees and directors who trade in their own stock.[2] But more importantly, as this Comment will show, the companies also have the power to permit insiders to trade on inside information in their own stock.

Part I identifies the regulatory and normative underpinnings of insider-trading regulation and describes how the regulations are perceived as a mandatory prohibition.[3] Part II challenges this view and argues that a corporation

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1. *See, e.g.*, *Guilty as Charged: The Verdict Is Finally In*, ECONOMIST, May 12, 2011, at 90; *SEC Enforcement Actions: Insider Trading Cases*, U.S. SEC. & EXCHANGE COMMISSION (Oct. 6, 2011), http://www.sec.gov/spotlight/insidertrading/cases.shtml ("Insider trading continues to be a high priority area for the SEC's enforcement program.").

2. For example, a company is perfectly able to forbid its employees, as a contractual matter, from trading in its stock. It may also use the federal securities laws to seek damages from employees who trade on inside information. *See* sources cited *infra* note 8.

3. In this Comment, I use the phrase "insider-trading regulation" to refer to federal regulation. But insider trading can also be the subject of derivative suits for breach of the duty of loyalty under state law. *See, e.g.*, Pfeiffer v. Toll, 989 A.2d 683 (Del.

may permit its employees to carry out the equivalent of insider trading on the corporation's own stock. Part III discusses the implications of this argument for the SEC's enforcement of insider-trading regulations.

I. Regulatory and Normative Underpinnings of Insider Trading

The literature on insider trading is vast, and I will review it only very briefly. The most important prohibition on insider trading is SEC Rule 10b-5.[4] Under what is known as the "classical theory,"[5] this rule is used to prohibit trading on material, nonpublic information by an individual who owes a fiduciary duty to the corporation whose stock is being traded. The rule can also be used to prohibit trading by an individual who "misappropriates" inside information in breach of a duty owed to the source of the information—whether or not that individual is a corporate insider.[6] These rules are all-encompassing and, on their face, mandatory: The SEC can pursue any person who violates them and seek civil or criminal penalties.[7] There is also a private right of action for persons harmed by insider trading.[8]

Some scholars have argued that insider-trading prohibitions should not be mandatory, and that shareholders should be able to choose whether to permit

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Ch. 2010) (discussing the duty of loyalty under Delaware law), *abrogated on other grounds by* Kahn v. Kolberg Kravis Roberts & Co., 23 A.3d 831 (Del. 2011) (reaffirming the duty of loyalty but modifying the precise standard).

4. 17 C.F.R. § 240.10b-5 (2012). There are two other insider-trading regulations. Section 16(b) of the 1934 Securities and Exchange Act prevents "short-swing" insider trading by officers, directors, and those holding a stake greater than ten percent in the company. 15 U.S.C. § 78p(b) (2006 & Supp. 2011). SEC Rule 14e-3 prohibits insider trading during tender offers. 17 C.F.R. § 240.14e-3 (2012).

5. *See* Chiarella v. United States, 445 U.S. 222, 229 (1980) (describing the classical theory, although not terming it as such). The phrase "classical theory" was used in *United States v. O'Hagan*, 521 U.S. 642, 652 (1997). Employees of a corporation owe a fiduciary duty to that corporation; third parties not employed full-time by a corporation, such as attorneys and consultants, can also "temporarily" owe a fiduciary duty to a corporation. Dirks v. SEC, 463 U.S. 646, 655 n.14 (1983).

6. *O'Hagan*, 521 U.S. at 652.

7. 15 U.S.C. § 78u-1 (2006 & Supp. 2011) (civil penalties); *id.* § 78ff(a) (2006) (criminal penalties).

8. An implied private right of action under Section 10(b) of the Securities and Exchange Act was first found by a court in *Kardon v. National Gypsum Co.*, 69 F. Supp. 512 (E.D. Pa. 1946). It has been reaffirmed repeatedly since. *See, e.g.*, Stoneridge Inv. Partners v. Scientific-Atlanta, Inc., 552 U.S. 148, 152 (2008). A private right of action is also available for violations of Rule 14e-3. *See, e.g.*, O'Connor & Assocs. v. Dean Witter Reynolds, Inc., 529 F. Supp. 1179 (S.D.N.Y. 1981). There is an explicit private right of action under Section 16(b) of the Securities and Exchange Act of 1934. 15 U.S.C. § 78p (2006 & Supp. 2011).

individuals to trade inside on their companies' stock.[9] These arguments have typically relied on the effect of insider trading on promoting efficient markets and its effectiveness as a compensation scheme.[10] Others have rebutted these arguments and contended that such trading should be banned.[11] But regardless of the merits of insider trading in general, there is no question that the federal regulations against it are seen as prohibitions.[12] And enforcement of these prohibitions is not limited to the SEC and private individuals. Indeed, public stock exchanges are also required to promote compliance with insider-trading laws.[13]

However, as the next Part shows, there are reasons to treat the body of law regulating insider trading as less of a general prohibition than it appears. Corporations are able to take advantage of state laws governing fiduciary duty to compensate their employees in ways that have effects that are similar to insider trading. This invites the possibility that, to some extent, a corporation may "permit" insider trading in its stock by its own employees.

II. Permitting "Insider Trading" Through Compensation Schemes

The Delaware courts have discussed two ways in which companies may mimic the effect of insider trading in their own stock.[14] First, a company may grant "springloaded" options as part of compensation. Awarding stock options as part of a compensation package is standard practice in corporations. However, as Chancellor Chandler pointed out in *In re Tyson Foods, Inc.*, granting springloaded options is different: "A compensation committee that 'spring loads' options grants them to executives before the release of material information reasonably expected to drive the shares of such options higher."[15] In *Tyson Foods*, the compensation committee granted options to executives at suspiciously well-timed moments—for example, a few days before the company released results that it knew would exceed analysts' expectations.[16] The plaintiffs

9. *See, e.g.*, Dennis W. Carlton & Daniel R. Fischel, *The Regulation of Insider Trading*, 35 Stan. L. Rev. 857, 894 (1983).

10. The classic expression of this view is found in Henry G. Manne, Insider Trading and the Stock Market (1966).

11. One argument that counsels toward prohibiting insider trading is that it is simply unfair. *See, e.g.*, *In re* Cady, Roberts & Co., 40 S.E.C. 907, 912 (1961) (discussing the "inherent unfairness" of insider trading).

12. *See, e.g.*, David D. Haddock & Jonathan R. Macey, *A Coasian Model of Insider Trading*, 80 Nw. U. L. Rev. 1449, 1451 (1986) (noting "the SEC's refusal to permit firms to opt out of its rules").

13. William K.S. Wang & Marc I. Steinberg, Insider Trading 613-14 (3d ed. 2010).

14. I focus on Delaware because of the state's dominance in the field of corporate law.

15. *In re* Tyson Foods, Inc., 919 A.2d 563, 576 n.16 (Del. Ch. 2007).

16. *Id.* at 576.

alleged that the board of directors violated its fiduciary duty by approving these options: The board's actions were deceptive, they claimed, because the company maintained in public that the springloaded options had been granted at market rates.[17]

Chancellor Chandler agreed: "Granting spring-loaded options, without explicit authorization from shareholders, clearly involves an indirect deception."[18] Such action violated the duty of loyalty toward shareholders. However, the phrase "without explicit authorization" is crucial: As the Chancellor went on to say, springloading could be legal if the options were issued without circumventing "otherwise valid shareholder-approved restrictions."[19]

In *Desimone v. Barrows*, then-Vice Chancellor Strine considered again the circumstances under which springloading would constitute a breach of fiduciary duty.[20] *Desimone* was a derivative suit involving allegations that the directors of a company had received springloaded options in breach of their duties to its shareholders. The Vice Chancellor noted that if the directors fully disclosed their motivations for receiving springloaded options, there would be no breach of fiduciary duty from the act of receiving the options itself.[21]

Although springloading is not necessarily a form of insider trading, as Chancellor Chandler suggested in *Tyson Foods*, it can accomplish similar results.[22] An individual who engages in insider trading attempts to profit by buying shares that, based on inside information, he thinks will appreciate in value, or by selling shares that the information suggests will depreciate. A company employee who receives springloaded options may exercise the options when the share price has risen, and thus replicate the economic effect of buying shares that are expected to appreciate.[23]

Springloading is related to another practice: "bullet-dodging."[24] When a corporation grants bullet-dodging options, it deliberately releases bad news before the options are issued. Vice Chancellor Strine noted the business logic of this practice in *Desimone*, where he observed that a failure to release bad news before the granting of the options could leave the recipient with "underwater"

17. *Id.* at 590.

18. *Id.* at 592.

19. *Id.* at 593.

20. 924 A.2d 908, 937-38 (Del. Ch. 2007).

21. *Id.* at 937 n.98. The Vice Chancellor noted that there might be an unrelated action for breach of fiduciary duty by receiving excessive compensation. *Id.*

22. *In re* Tyson Foods, 919 A.2d 563, 593 (Del. Ch. 2007).

23. The recipient of the options may not replicate the entire effect of insider trading: He will not own the stock, and therefore he cannot exercise voting rights.

24. *See Desimone*, 924 A.2d at 943.

options.[25] Like springloading, bullet-dodging can be analogized to insider trading. Although it does not replicate the effect of trading on stock that is expected to appreciate, bullet-dodging does imitate the effect of successfully timing the market. The person who receives bullet-dodging options whose value is linked to the issuing corporation's stock price at the time of granting is in a similar situation to the person who buys shares when the market is in a trough, rather than at a peak.

If a corporation's shareholders specifically empower the compensation committee to grant springloaded or bullet-dodging options to employees, these individuals would profit from the "inside" information, but the corporation would be in no breach of fiduciary duty under *Tyson Foods* and *Desimone*. Nor would the behavior be illegal under federal securities laws. The approval of the corporation's shareholders would shield the compensation committee and the recipient of the options from charges of breaches of fiduciary duty or misappropriation of confidential information, and would provide a defense to charges of breaching Rule 10b-5.[26]

The practice of granting stock options typically is limited to company executives. But there is, in theory, no reason why it could not be extended to employees in general. Shareholders could vote to permit a corporation to grant springloaded or bullet-dodging options to all employees. Such a scheme would be very unusual, but it is theoretically achievable. For example, the corporation could stipulate, by contract, that employees would not be permitted to trade the stock of the corporation, but that if they were to have any successes deemed likely to lead to a rise in the share price of the company, they could apply to the compensation committee to be granted springloaded options as a reward.[27] (A corporation could not, on the other hand, institute a general scheme involving bullet-dodging: It would be bizarre, to say the least, for a compensation committee to reward employees with bullet-dodging options in anticipation of a *fall* in the share price.)

Because corporate directors, officers, and employees may legally mimic the effect of insider trading, the federal prohibition on insider trading may be less mandatory than conventionally thought. For its part, the SEC appears to accept the possibility of springloading: It has adopted regulations that require a corporation to explain any springloading to its shareholders.[28] The existence of

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25. *Id.* at 944-45. "Underwater" options are options whose exercise price is higher than the current price of the stock; in other words, the owner of the options has no incentive to exercise them.

26. *See supra* notes 5-6 and accompanying text.

27. For example, if a mining company wishes to reward geologists who discovered a particularly rich vein of ore, it could grant them options before the news of the discovery reached the market. This was the scheme in *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968).

28. *See* 17 C.F.R. § 229.402(b) (2012).

springloading and bullet-dodging has implications for the regulation of insider trading.

III. Prioritizing Enforcement of Insider Trading

A. *Conceptualizing Insider Trading as a Default Rule*

Because a corporation may legally permit its employees to use inside information for financial advantage, the SEC's prohibition on insider trading should be seen not as a "mandatory" rule but rather as a "default" rule. Mandatory rules are, as the term implies, categorical commands that cannot be waived by the parties concerned. Default rules, on the other hand, are rules that can be contracted around by the parties.[29]

The default rule against insider trading by employees is very "sticky," or difficult to contract around,[30] since it is hard for a compensation committee to receive shareholder approval to award springloaded or bullet-dodging options. This sticky default rule prohibiting insider trading can thus alternatively be viewed as a default with an "altering rule" that is very difficult to use. An altering rule is a rule that permits a party to toggle from the default setting to the alternative setting. The altering rule that governs insider-trading regulations can be termed an "impeding" altering rule in that it strongly encourages parties to stick to the default.

Of course, it is true that if a corporation chooses to use the altering rule and grant springloaded or bullet-dodging options, it does not implement a scheme that has all the ill effects of insider trading. The effect of springloaded or bullet-dodging options is to transfer the company's resources from shareholders in general to employees. Insider trading in its simplest form—the buying or selling of shares in the open market—affects certain shareholders (i.e., those who are unfortunate enough to be on the other side of the bargain) while leaving others unaffected (i.e., those who do not buy or sell).[31] Because this kind of insider trading places all of the burden on some shareholders while leaving others untouched, it seems more unfair than grants of springloaded or bullet-dodging options, where the burden is borne by all shareholders.

Nevertheless, the legality of springloading and bullet-dodging militates in favor of treating insider trading as a default rule. Giving springloaded options

29. For the seminal exposition of the uses of default rules as opposed to mandatory rules, see Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 YALE L.J. 87 (1989).

30. *See* Ian Ayres, *Regulating Opt-Out: An Economic Theory of Altering Rules*, 121 YALE L.J. 2032 (2012). The following discussion of altering rules relies on this work.

31. Indeed, shareholders who are not counterparties to a trade made on the basis of inside information may in fact *benefit* from the trade, as the trade has revealed information to the market and thus may make the corporation's share price more accurate. *See supra* note 10 and accompanying text.

without shareholder approval is undoubtedly insider trading, as the Court of Appeals for the Second Circuit noted in *SEC v. Texas Gulf Sulphur Co.*[32] And while the granting of springloaded options is different from the simplest form of insider trading (i.e., buying or selling stock in the market) in that the former potentially has a broader base of victims, this difference is one of degree and not kind[33]: Both involve the transfer of company resources to those who possess material, nonpublic information. With this in mind, I turn now to the question of whether viewing the prohibition on insider trading as a default rule, rather than a mandatory rule, should affect how the SEC attempts to enforce it.

B. *SEC Enforcement of Insider Trading*

The argument that the SEC should see "outsider" trading as more important than insider trading rests on two principles: (1) the prohibition on insider trading can be considered a default rule, and (2) there is a private right of action for insider trading.

Conceptualizing insider trading as a default rule means that insider trading is susceptible to private contracting. (Recall that a default rule, as opposed to a mandatory rule, is a rule that can be contracted around.[34]) From here, we can conceive of insider-trading regulations as constituting a contract between shareholders and the corporation, just like other aspects of the corporate form.[35] The existence of a private right of action for failure to abide by these regulations reinforces the notion that insider-trading regulations constitute a private contract. Private contracts are, of course, enforceable *only* through the private rights of action that one party has if the other party is in breach, and the ability of shareholders to choose whether to sue to enforce the insider-trading regulations makes these regulations akin to private contracts.

The resemblances between private contracts and the insider-trading regulations that affect corporate employees do not mean that the SEC should never be involved in enforcing the regulations. It is not unusual for securities regulations to consist of what are effectively "default rules" and "altering rules," combined

32. 401 F.2d at 856-57.

33. In the long run, this difference may even out. Insiders usually make transactions on only a very small percentage of a corporation's stock at any one time. Therefore, a shareholder who loses out in one insider trade may, by the laws of probability, avoid being the victim of other insider trades, provided that he has not sold the entirety of his stake in the corporation. Over the long term, it is possible that shareholders may be affected more or less equally. When companies use techniques such as springloading and bullet-dodging, all shareholders are affected equally.

34. *See supra* text accompanying note 29.

35. *See* Frank H. Easterbrook & Daniel R. Fischel, *The Corporate Contract*, 89 COLUM. L. REV. 1416, 1418 (1989) ("The corporation is a complex set of explicit and implicit contracts . . . .").

with provisions that permit joint state and private enforcement.[36] Nevertheless, the fact that a regulatory provision can be contracted around implies that it can be seen as less of a priority for state enforcement than one that cannot be contracted around. Mandatory rules are mandatory because of their importance. Default rules, on the other hand, permit deviation. The very fact that parties can choose between one of two or more options shows that the default provision is less important than an equivalent mandatory provision would be.

On the other hand, the rules governing insider trading by nonemployees—that is, outsiders—cannot be contracted around in this way. A compensation committee cannot grant springloaded or bullet-dodging options to nonemployees because they do not receive compensation from the corporation. With respect to outsiders, therefore, the insider-trading regulations seem to be genuine mandatory prohibitions, and not (sticky) default rules. The regulations as applied to outsiders, because they are mandatory, appear to be more important than the default regulations applied to insiders.

It follows that the SEC should see insider trading by company insiders as less of a priority for enforcement than insider trading by outsiders. It is worth noting that the default rule against insider trading can be adjusted in two directions: It can be relaxed, but it can also be strengthened. A corporation is able to ban its employees from all trading in its stock and even its competitors' stock—regardless of whether this trading is on the basis of material, nonpublic information—through its power to set the contractual terms of employment for its employees.[37] Therefore, a corporation may have a panoply of contract rights on which it can rely in addition to the rights provided under Rule 10b-5. The SEC, in contrast, can use only the federal regulations.

This is not to say that companies should permit insiders to trade on their own stock. As a threshold matter, stock exchange regulations forbid insider trading, and a corporation whose shareholders voted to permit insider trading

36. For example, Section 5(b) of the Securities Act of 1933 forbids sending a prospectus for any security for which a registration statement has been filed, unless the prospectus meets the requirements of Section 10 of the Act. 15 U.S.C.A. § 77e (West 2012). The prohibition on sending the prospectus can be seen as the default rule, and compliance with the requirements of Section 10 can be seen as the altering rule. There is a private right of action for noncompliance with these rules under Section 12 of the Securities Act. *See* 15 U.S.C. § 77*l* (2006). Judge-made securities laws also provide examples. Misstatements and omissions in prospectuses are actionable, unless they are hedged with sufficient cautionary language. *See, e.g.*, *In re* Donald J. Trump Casino Sec. Litig., 7 F.3d 357 (3d Cir. 1993). In this example, the prohibition against misstatements and omissions can be seen as a default rule, and the inclusion of cautionary language can be seen as an altering rule. Once again, private remedies are available in this situation. *Id.* at 365-66.

37. *See supra* note 2. For a discussion of how an insider might reproduce the effects of insider trading by trading in a competitor company's stock, see Ian Ayres & Joseph Bankman, *Substitutes for Insider Trading*, 54 STAN. L. REV. 235 (2001).

would risk being delisted.[38] More importantly, shareholders might have little interest in permitting insider trading in their corporation's stock.[39] But the foregoing argument does suggest that the SEC should prioritize its enforcement actions in favor of enforcing the rules on outsider trading, not insider trading.

Nor does this argument imply that the SEC should completely disavow enforcement of insider-trading regulations against employees and directors. The SEC has a huge institutional advantage over private plaintiffs in terms of the expertise it brings to the investigation of insider-trading scandals, and this advantage carries over into insider-trading enforcement actions as well.[40] Moreover, much of the process of detecting insider trading is automatic: Stock exchanges, which are regulated by the SEC, have automated systems for monitoring unusual trading patterns.[41] This indicates that the SEC should continue to lead the process of detecting violations of the insider-trading laws. But there are different ways in which the SEC may choose to discharge its enforcement authority. As some scholars have observed, the SEC could lead an insider-trading investigation and then hand over the evidence to the affected corporation to "prosecute" the matter itself.[42] In other words, if the SEC were to pri-

38. *See* WANG & STEINBERG, *supra* note 13, at 613-14. Although national stock exchanges also play a role in enforcing compliance with insider-trading rules, a change in enforcement strategy by the SEC would still have real effects. First, the SEC has broad powers over the formal enforcement actions that stock exchanges take. 25 MARC I. STEINBERG & RALPH C. FERRARA, SECURITIES PRACTICE: FEDERAL AND STATE ENFORCEMENT § 14:3 (2011). Second, the SEC can also influence the informal enforcement practices of the stock exchanges. *Id.* § 14:6. Third, it is arguable that stock exchanges derive much of their motivation to enforce rules from the SEC—and that when the SEC is unwilling to take action itself, the stock exchanges will not take action. This is partially due to the fact that stock exchanges do not have "ideal incentives" to enforce insider-trading laws. Robert Prentice, *Whither Securities Regulation? Some Behavioral Observations Regarding Proposals for Its Future*, 51 DUKE L.J. 1397, 1440-41 (2002) (quoting John C. Coffee, Jr., *Privatization and Corporate Governance: The Lessons from Securities Market Failure*, 25 J. CORP. L. 1, 32 (1999)). Therefore, the shared role of the SEC and the stock exchanges in enforcing insider-trading rules does not prevent the SEC from taking effective action on its own.

39. Permitting insider trading might deter investment and trading in the stock, as shareholders would suspect that their counterparties had superior information that would give them a bad bargain. Insider trading also risks causing agency problems that would affect the firm's performance. Robert J. Haft, *The Effect of Insider Trading Rules on the Internal Efficiency of the Large Corporation*, 80 MICH. L. REV. 1051 (1982).

40. Stephen M. Bainbridge, *Incorporating State Law Fiduciary Duties into the Federal Insider Trading Prohibition*, 52 WASH. & LEE L. REV. 1189, 1263, 1265 (1995).

41. *Id.* at 1263.

42. *See* JONATHAN R. MACEY, INSIDER TRADING: ECONOMICS, POLITICS, AND POLICY 40-41 (1991); Douglas M. Branson, *Discourse on the Supreme Court Approach to SEC Rule 10b-5 and Insider Trading*, 30 EMORY L.J. 263, 302 (1981).

oritize outsider-trading enforcement, it could turn over evidence of insider trading to a corporation for a private enforcement action.

This suggestion would be difficult to carry out without changes to the regulatory regime. Even if the SEC were to exercise its discretion and choose to reduce enforcement actions against certain kinds of insider trading, stock exchanges must still enforce compliance with insider-trading rules. Without the necessary regulatory changes, a stock exchange could not simply choose to ignore a certain type of insider trading. But even without regulatory changes, the SEC can focus on insider trading that is more likely to be the work of outsiders or can seek harsher penalties in cases involving such trading. The SEC can thereby use its discretion over enforcing insider-trading regulations to shift policy in the way that this Comment suggests.

Conclusion

This Comment has argued that federal insider-trading regulation should be seen as a default rule, not a mandatory rule, when applied to persons who are trading on inside information in their own company's stock. The methods by which corporations can imitate the effects of insider trading—that is, giving directors and employees springloaded or bullet-dodging options—do not perfectly correspond to insider trading as it is practiced. But they do demonstrate that the employees of a corporation can be authorized to act in ways that, but for the consent of the shareholders, would be a violation of fiduciary duty and would be illegal. The SEC should recognize that the prohibition against insider trading as applied to the employees and directors of a company can be seen as a default rule and should adjust its enforcement accordingly.