Testimony of

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Illegal insider trading involves the theft of valuable information about corporate plans that properly belongs to the corporation and its investors. Vigorous enforcement of the laws against insider trading is important to protect the intellectual property rights of investors and corporations.

Trading by insiders is not always illegal. It is illegal when securities are traded in breach of a relationship of trust and confidence (a "fiduciary duty:), on the basis of material, nonpublic information that reasonably can be expected to affect the price of the securities being transacted. In addition to trading, it also is illegal to tip information in violation of a fiduciary duty and to misappropriate confidential information.

Properly understood, there is no serious argument that insider trading in breach of a fiduciary duty is a "victimless" crime. While the intuition that insider trading is "bad" and "wrong" is widely shared, the reasons why some, but not all, trading by insiders is and should be illegal is not well understood.

Insider trading is bad and wrong for the same reason that stealing is bad and wrong. It deprives people of what is rightfully theirs, and in doing so, undermines legitimate societal trust and expectations about how markets should operate. This property rights oriented approach to the law of insider trading is consistent with the case law as developed over time by the U.S. Supreme Court in the landmark cases of U .S. v. Chiarella, (1980), Dirks v. Securities and Exchange Commission (1983), and U.S. v. O'Hagen (1997).

Thus, for example, when an officer, or director, or a professional such as a lawyer, accountant or investment banker, trades for personal profit on the basis of confidential corporate information about a forthcoming earnings announcement, or merger, that person has taken (misappropriated) valuable information. The problem with doing this is that it reduces the incentives of legitimate market participants, like analysts, to allocate scarce resources to engaging in research because insiders will appropriate the trading profits associated with making discoveries of information before the analysts can get to it. And, of course, insider trading ultimately robs investors of many of the benefits of investing; by depriving them of the ability to avoid losses or to make gains from their own research or from the research they are buying directly and indirectly from institutions, professional advisers, portfolio managers and mutual funds. Finally, insider trading increases the transactions costs of investing; particularly by increasing the bid-asked spreads associated with buying and selling securities in public debt and equity markets. For these reasons, regulation of insider trading protects investors and, in doing so, encourages the development of high quality capital markets.

How much insider trading do we actually observe, and could we do more to stop it?

Here I wish to make the following points.

1) The available empirical evidence makes it clear that the U.S. has, by far, both the most vigorous insider trading enforcement program in the world, as well as the

strictest laws against insider trading.
2) The USA is the country in which insiders' profits are lowest.1
1 See Arturo Bris, "Do Insider Trading Laws Work?" . European Financial Management, Vol. 11, No. 3, pp. 267-312
3) In the U.S. there is a private right of action for violation of the laws against insider trading. The private plaintiffs bar generally "piggy backs" on the vigorous efforts of the Enforcement Division of the Securities and Exchange Commission. This, in turn, suggests that the vigorous public enforcement program of the SEC, which includes 250 insider-trading enforcement actions over the past five years, is highly effective. By contrast, in the UK there have been just 14 insider trading convictions since 1980, and the largest fine 25,000 pounds in 1987, is lower than the average penalty in the U.S. Community service is the most common penalty in the UK.
4) The enforcement program of the Securities and Exchange Commission is broad and wide-ranging. Cases brought by the SEC include actions against:
a. Corporate officers, directors, and employees who traded the corporation's securities after learning of significant, confidential corporate developments;
b. Friends, business associates, family members, and other "tippees" of such officers, directors, and employees, who traded the securities after receiving such information;
c. Employees of law, banking, brokerage and printing firms who were given such information to provide services to the corporation whose securities they traded;
d. Government employees who learned of such information because of their employment by the government; and
e. Other persons who misappropriated, and took advantage of, confidential information from their employers.2

5) As the Supreme Court made clear in Dirks, not all trading on the basis of information not reflected in share prices is, or should be, illegal. In particular, trading that is not done in violation of a fiduciary duty, and involves profit-taking from investments in legitimate research about corporate performance or governance is socially valuable and should be encouraged.
6) Studies that increases in trading volume or share prices in advance of merger and acquisition activity fail to distinguish between legitimate and illegitimate insider trading activity. For example, purchases by a hedge fund, LBO fund, arbitrageur or large equity investor may actually put a company "in play," increasing the chances of an outside acquisition attempt. These highly beneficial market activities will increase the trading volume and the share price of the target company, but are not always consistent with insider trading despite press reports the contrary (See Gretchen Morgenson, "Whispers of Mergers Set Off Bouts of Suspicious Trading," The New York Times, August 27, 2006.
7) Stock exchanges, despite their other self-regulatory problems, have strong incentives to monitor and control insider trading, at least by non-exchange officials.
8) In considering the question of whether more is needed, it is important to consider the fact that increased prosecutions may reduce so-called "type-one error" by reducing the amount of illegal insider trading that goes undetected and un- prosecuted; but it also inevitably will increase the amount of "type-two error" in http://www.sec.gov/answers/insider.htm
that it will increase the incidence of costly investigations of legal and legitimate trading activity.
9) One of the great inchoate assets of U.S. capital markets is the complex array of cultural norms that provides behavioral guidelines for professional market participants such as lawyers,

accountants and investment bankers. An important aspect of this system of norms is the fact that, in U.S. trading markets, unlike many other markets, insider trading is not a professionally accepted market practice. People who engage in insider trading, and even people accused of insider trading, particularly those who work in the capital markets in a professional capacity, are viewed as pariahs. In other words, the reputational penalties for insider trading in the U.S. are very high. The SEC in its enforcement program does an excellent job of balancing the important public policy goal of detecting and punishing insider trading with the important public policy goal of conducting insider trading investigations in a careful and professional manner so as to not needlessly ruin the professional reputations of innocent people. In doing so, the SEC has been able to preserve the priceless deterrent effect of the social stigma associated with insider trading in U.S. capital markets.