Testimony of

James D. Cox

Before

Committee on the Judiciary

United States Senate

September 26, 2006

on

Insider Trading

My name is James D. Cox. I am Brainerd Currie Professor of Law, School of Law, Duke University where my research and teaching focuses on securities and corporate law. Prior to coming to Duke in 1979, I taught at Boston University, University of San Francisco, University of California, Hastings College of the Law, and Stanford University School of Law. I have in the recent past been a member of the New York Stock Exchange Legal Advisory Committee and the National Association of Securities Dealers Legal Advisory Board. Among my publications are Securities Regulations: Cases and Materials (5th ed. Aspen 2006)(with Langevoort and Hillman) which has been adopted in approximately two-thirds of American law schools.

I submit this statement and appear before the Subcommittee on behalf of no organization and the costs incurred in connection with my appearing before this committee are being borne entirely by myself. I appreciate the research assistance in preparing this statement of Ms. Nicole

M. Guerroro who is a second-year student at the Duke University School of Law.

I. Big News Equates To Poorly Kept Secrets

The financial rewards of trading in securities markets on confidential material information are large. Unfortunately, not everyone resists the temptations of these large rewards so that there is ample empirical evidence that there is significant trading in securities markets on the basis of secret advance knowledge of material non public information bearing on such diverse topics as a merger, takeover, earnings announcement, or product development. The following paragraphs provide a brief summary of the leading empirical studies supporting these statements.

Initial studies of insider trading examined whether insiders (officers, directors and certain beneficial owners) who are required to report their trading pursuant to section 16(a) of the Securities Exchange Act abuse their informational advantage by trading on non public information. Jaffe, Special Information and Insider Trading 47 J. Bus. 410 (1974) and Finnerty, Insiders and Market Efficiency, 31 J. Fin. 1141 (1976), each find that insiders garner significant abnormal returns, an observation consistent with insiders deploying confidential corporate information to their personal advantage. Not captured by Jaffe and Finnerty is the extent, if any, that insiders share their good fortune with their friends and relatives through tipping so that the ill-gotten gains are more pervasive than those reaped by the director, officer or beneficial owner of a reporting company who file section 16(a) reports. If there is a silver lining is this cloud that hangs over our securities markets, it is that there is evidence that insider trading not only drives securities prices in the direction of the post-announcement equilibrium level but appears also to be related to price-discovery efforts by "uniformed" traders who can be seen as jumping on the momentum provided by the informed trading by insiders. *See* Meulbroek, An Empirical Analysis of Illegal Trading, 47 J. Fin. 1661 (1992). This "positive"byproduct, however, should not detract from our condemnation of the substantial first mover advantage insiders enjoy. *See* Cox, Insider Trading and Contracting: A Critical Response to the "Chicago School," 1986 Duke L. J. 628 (claims of efficiency associated with insider trading are overstated as insider trading is slow and clumsy method to impart newsworthy information vis-a-vis a clarion corporate announcement).

Mergers and takeovers are particularly rife with insider trading abuses in the pre-announcement period. This is because they inherently involve significant market premiums to the acquired firm and because their planning and execution involve a large number of individuals each of whom faces the temptations of certain gains and uncertain detection should they decide to trade on their advance knowledge of the transaction. Each study of trading surrounding acquisitions consistently demonstrates that leakage and abuse of inside information is a pervasive problem in connection with mergers and takeovers. Among the earliest studies, using monthly stock price data, Halpern Empirical Estimates of the Amount and Distribution of Gains to Companies in Megers, 46 J. Bus. 554 (1976), found that as one moves closer to the first public announcement of the acquisition that excess (above market returns) returns garnered by owning shares of the target firms increases, an observation consistent with inside trading based on knowledge of the acquisition. *See also* Mandelker, Risk and Return: The Case of Merging Firms, 1 J. Fin. Econ. 303 (1974)(also using monthly data and reaching the same result). Using daily price data, Keown & Pinkerton, Merger Announcements and Insider Trading Activity: An Empirical Investigation, 36 J. Fin. 855 (1981), report that significant evidence of insider trading appeared on average 12 days prior to the first public announcement of a merger in 194 studied merger announcements. About 40-50 percent of the price gain experienced by the targets of takeovers occurs *before* the actual takeover announcement. Keown & Pinkerton, *supra*. Some might speculate, erroneously however, that the price run up in advance of takeover is due to lawful market trading by astute investors who "anticipate" mergers and takeovers. This hypothesis is rejected by the findings of Eyssell & Arshadi, Insiders, Outsiders, or Trend Chasers? An Investigation of Pre-Takeover Transactions in the Shares of Target Firms, 16 J. Fin. Res. 49 (1993). Indeed, trading based on public rumors were found not to generate any abnormal returns. Pound & Zechhauser, Clearly Heard on the Street: The Effect of Takeover Rumors on Stock Prices, 63 J. Bus. 291 (1990). The stock market is not the only venue where the insiders reap the rewards of their significant informational advantage; data confirms that put and call options are astutely used by insiders to reap gains in the pre-takeover period. *See* Arnold, Erwin, Nail & Bos, Speculation or Insider Trading: Informed Trading in Options Markets Preceding Tender Offer Announcements, Working Paper (May 2000) available at http://ssrn.com/paper-234797; Jayaraman, Frye & Sabherwal, Informed Trading Around Merger Announements: An Empirical Test Using Transaction Volume and Open Interest in Options Market, _ Fin. Rev. __ (2001). Finally, it should be observed that climate appears not to dampen the frequency of inside trading in advance of takeover; a study of trading in advance of takeover announcements of 420 Canadian companies found significant price and volume changes in the subject companies in the days preceding the first public announcement of a takeover. *See* King & Padalko, Pre-Bid Run-

Ups Ahead of Canadian Takeovers: How Big is the Problem?, Bank of Canada Working Paper 2005-3. *See also*, Bris, Do Insider Trading Laws Work?, Working Paper Yale School of Management Oct. 2000 (study of 5,099 acquisitions in 56 countries finding significant profits garnered by insiders' trading prior to takeover announcement).

Earnings announcements have also been studied for possible insider trading. Park & Jang, Insider Trading Activity Surrounding Annual Earnings, 22 J. Bus. Fin. & Accounting 587 (1995), find that insider trading systematically occurs several weeks prior to earnings announcements but not immediately preceding the announcement; they speculate the absence of trading in close proximity to the earnings announcement reflects the insider's fear of being charged with insider trading. A similar pattern is supported by the findings of Ke, Huddart & Petroni, What Insiders Know About Future Earnings and How They Use It: Evidence of Insider Trades, 35 J. Accounting & Econ. 315 (2003)(insiders sales increase three to nine quarters prior to a break in earnings but there is little abnormal selling in two quarters immediately prior to a break in historic track of earnings increases). What emerges from this work is a pattern of officers and directors being averse to sell in close proximity to a break/unexpected decline in reported earnings while there is evidence that insider purchases peak much closer (within a month generally) to a large jump. *See* Marin & Olivier, The Dog That Did Not Bark: Insider Trading and Crashes, Working Paper Department of Econ. & Bus, Universitat Pompeu Frabra, (2006). *See also* Huddart, Ke & Shi, Jeopardy, Non-Public Information, and Insider Trading Around SEC 10-K and 10-Q Filings, _ J. Accounting & Econ. (Forthcoming 2006), available at http://ssrn.com/paper=756124 (Insiders avoid trading in close proximity to significant earning announcements in documents filed with SEC). Finally, insiders appear to systematically exploit their information advantage regarding the firm's securities being listed or delisted on the NYSE or AMEX. *See* Lamba & Khan, Exchange Listings and Delistings: The Role of Insider Information and Insider Trading, _ J. Fin. Res. _ (   ).

II. Some Regulatory Choices

In broad overview, there are two well recognized routes policymakers can pursue to reduce the frequency and magnitude of misconduct: increase the probability that wrongdoers will be detected and successfully prosecuted, and policy makers can also enhance the sanctions to be imposed in such a successful prosecution. Over the past two decades, the Congress has moved aggressively on each of these two fronts. Certainly the enforcement budget of the SEC has grown significantly since 2001 and the pay-parity provision enacted by Congress has done much to retain senior leadership at all levels of the SEC. In 1988, Congress also externalized enforcement of insider trading prohibitions by imposing unique control person obligations upon broker-dealers and certain other market professionals so that vicarious liability could be imposed upon them unless they maintained a reasonable system of surveillance to discourage insider trading by employees. *See* Securities Exchange Act Sections 15(f) and 21A(b), 15 U.S.C. §§ 78o(f) & 78u-1(b). The legislation also introduced a novel "bounty hunter" mechanism to encourage third parties to identify individuals engaged in insider trading. Securities Exchange Act Section 21A(e), 15 U.S.C. § 78u-1(e). And, in 1988, Congress expressly authorized private actions for insider trading. Securities Exchange Act Section 20A, 15 U.S.C. § 78t-1. Penalties for insider trading were significantly increased with the enactment of the Insider Trading

Sanctions Act of 1984 which authorizes the SEC to recover up to treble the insider's profits. Securities Exchange Act Section 21A(a)(2), 15 U.S.C. § 78u-1(a)(2). Among the many contributions to enforcement by the Sarbanes-Oxley Act of 2002 are significant increases in criminal sanctions for several statutes commonly relied upon in criminal prosecutions of insider trading. *See e.g.*, Sarbanes Oxley Act Section 903 (increasing penalty for mail and wire fraud provisions). Sarbanes-Oxley also established a new criminal statute focused exclusively on securities fraud. *See* Sarbanes-Oxley Act Section 807 amending 18 U.S.C. § 1348. Against these developments it is fair to ask what more can be done? The following offers some areas the Senate Judiciary Committee may wish to pursue in answering this question.

A. Market Surveillance Efforts

As the members of this committee are aware, an important cornerstone of our regulation of securities markets is the commitment of self regulatory organizations to shoulder their fair share of the burden of policing our securities markets. There are multiple benefits of self regulation. True professionalism arises from a profession's understanding that their members have public obligations and as a group they have a responsibility to improve the standards of their members so as to fulfill society's expectations. After all, being a member of a profession, as Dean Roscoe Pound observed, is more than being a member of a group of grocery merchants. R. Pound, The Lawyer from Antiquity to Modern Times 7 (1953). Self regulation also places responsibility with those who likely have the greatest acuity to the operation of the enterprise to be regulated. Thus, there are efficiency gains via self regulation. Not the least of these benefits are that it is the profession's resources and not the national government's resources that are placed into the regulatory breach. Nevertheless, we are well advised to heed the wise observation of the SEC's second chairman, William O. Douglas, who supported the view of "letting the exchanges take the leadership, with the Government playing a residual role." But he further cautioned, "[g]overnment would keep the shotgun, so to speak, behind the door, loaded, well-oiled, cleaned, ready for use but with the hope that it would never have to be used." W.O. Douglas, Democracy and Finance 64-65 (J. Allen ed. 1940).

Against the vivid image suggested by Justice Douglas, it is appropriate for this Committee to inquire whether the surveillance efforts of the self regulatory organizations have kept pace with market and regulatory developments. In an earlier and simpler time, the "Stock Watch" consortium of the trading markets such as Nasdaq and NYSE closely monitored listed companies to detect, among other matters, the likelihood of insider trading. In the last few years numerous changes have come to our securities markets that suggest the incentives for trading on inside information are greater than they were in earlier times and that self regulation may be more problematic today than in the past. These changes include decimalization, securities markets becoming dominated by institutional trading, the rising role of short-term trading strategies such as those engaged in by many hedge funds, and the demutualization of our major trading markets. Thus, we should inquire whether the SRO's market surveillance budgets, staffing levels, and computer technology are ahead or behind of the curve? More specifically, what is the present capability of the SROs ex post to, for example in the connection with takeover announcement, to reconstruct trading in the shares of the target company with sufficient precision to identify traders with possible pre-announcement access to knowledge of the takeover? A related question is how electronic surveillance and data bases can be improved to better detect insider trading? Do the SRO's have the best available technology to ferret out possible insider trading? These lines of question are hopeful avenues of exploration toward the goal of increasing the probability that insider trading will be detected. With greater likelihood of detection there comes greater deterrence of insider trading. The focus of these questions should not be limited to self regulatory organizations that oversee our securities market but should also include those responsible for our derivative markets, since the before-referenced studies support the view that inside trading occurs frequently through financial derivatives.

B. Are More Sanctions Needed?

Increasing the severity of existing sanctions in theory should reduce the frequency and magnitude of insider trading. Because the sanctions that exist today for insider trading are substantial, my intuition is that further ratcheting up of the sanctions will yield at best only marginal benefits. Instead of changing the sanctions, we can benefit from some of the empirical insights set forth above as well as evidence coming to light in the wake of the backdating of stock options epidemic that continues to earn headlines in our national press. Several of the above studies suggest that officers and directors do not trade in close proximity to earning announcement dates. This finding likely reflects their belief that there is a greater risk of detection should they trade too close to the date of the announcement. Such probable detection is facilitated because the officers, directors and owners of more than ten percent of the equity of a reporting company must promptly file with the SEC notice of any change in their holdings of their firm's shares. The Committee should be aware that studies of stock option backdating reveal that post-Sarbanes-Oxley, option backdating largely ceased. The infrequency of backdating of options post-Sarbanes-Oxley is because of a two-day window within which the option grant must now be reported. Thus, prompt disclosure of granting of options has achieved the desirable consequence of squelching the opportunity for option backdating. To be sure, individuals can always violate these requirements. For example, officers and directors could seek to avoid their section 16 reporting requirements by purposely failing to file the required information with the SEC. Thus, a fair question to ask is what is the level of compliance with these trading reporting requirements and how even greater compliance can be achieved.

The suggestion I offer here is that we consider imposing some greater transparency, at least to market regulators, of trading by professionals (such as investment bankers, attorneys, and bankers) of the type that regularly are involved with in acquisitions, takeovers, and other significant market activities for which evidence supports the view that there is massive insider trading. This transparency may involve no more tweaking of the system than to assure that the SRO's market surveillance data bases include information that could quickly match such a professional to a pre-announcement trade. It is my opinion that a reliable system that allows the SRO's to review trading in the pre-announcement period for evidence that individuals engaged in the "deal" would greatly enhance the deterrence capability of our existing insider trading laws. I also remain hopeful that such a regulatory structure could be devised that is consistent with our commitments to individual privacy.

In closing, I appreciate the opportunity you have provided me to share this information and ideas with you. I look forward to working with you and your staff as questions arise in your deliberations of this important matter.