BRIEFLY NOTED

Questioning the SEC's Crusades

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The United States Securities and Exchange Commission (SEC) enjoys a good reputation for honesty and competence, and is regularly hailed for preventing fraud, manipulation, and unfairness in American stock trading. And no area of SEC regulation has achieved more popular approval than its crusade against that scourge of stock market morality, insider trading.

However, the real truth about SEC regulation in general, and insider trading regulation in particular, may be far less laudable than is claimed by the SEC and its allies in academia, at the bar, and on Wall Street. Their praise fails to acknowledge (or perhaps realize) that, from its inception, American securities regulation consistently has benefited politically powerful financial interests, and that only competition and newer forms of communications technology — not the SEC — have disrupted those cozy arrangements.

IN THE BEGINNING....

The most famous effort by the SEC to benefit established financial interests at the expense of the investing public was the campaign to help the New York Stock Exchange (NYSE) preserve its now-defunct price-fixing rule for brokerage services. The Big Board's "fixed-commission-rate structure," the very heart of its alleged cartel power, had existed from the exchange's inception in 1792. But, as eventually happens with all cartels, cheating by price cutting, kickbacks, rebates, and special favors of all kinds had become a way of life among NYSE firms by the late 1950s. The problem was exacerbated by the growing demand from financial intermediaries, like mutual funds, for lower commission rates on large-block trades.

The situation threatened to overwhelm the SEC, which had concurrent enforcement authority with the NYSE over the commission rate structure. As then-chairman Manny Cohen complained, "Almost every regulatory problem we have concerning the securities markets is related in some way to the level or structure of rates prescribed by the minimum commission rules of the New York Stock Exchange."

Still, the SEC struggled to preserve this most sacred of Wall Street interests, and its efforts did not fully cease until 1975, when Congress ordered an end to the ancient rule. By then, effective cheating and new forms of competition had rendered the rule nearly meaningless, largely dissolving the available monopoly rents that had kept Congress sympathetic.

THE CRUSADE BEGINS

The SEC's renowned crusade against insider trading may well have begun as part of the 1950s push to enforce the price-fixing rule. At that time, the NYSE and SEC became concerned with discretionary brokerage accounts, which they believed were being used as an efficient and stealthy cartel-busting device.

Still a standard brokerage technique, discretionary accounts allow brokers to buy or sell in a customer's account without prior approval for each transaction. If the broker uses reliable, undisclosed information in those trades, the favored customers are guaranteed an abnormal rate of return on their stock market dealings. And if the inside information does not have to be disclosed to the customers, then brokers can use it repeatedly, up to a point. In the era of the price-fixing rule, the practice had the same effect as overt price discrimination, because the favored customers commissions were lowered, in a sense, by the amount of their excess gain.

That was precisely the scheme described in almost lurid detail in the SEC's seminal attack on insider trading, *Cady Roberts and Co.* (1961). At the time, observers were mystified by the agency adjudication because the facts appeared to indicate that only a normal broker-dealer disciplinary action was called for. However, the SEC's opinion, while technically addressing only brokers' behavior, was cast in terms of a general attack on insider trading under the SEC's catchall antifraud rule, Rule 10b-5.

The SEC's approach obviously helped enforce the cartel pricing system because it, in effect, outlawed the use of inside information as a rebate device. For that reason, it

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was not apt to be opposed on Wall Street. Additionally, it converted part of the SEC's cartel enforcement effort into a moral crusade against insider trading, probably a more politically acceptable mission (even though there was no popular demand for an insider trading rule).

The war against insider trading subsequently took on a life of its own. In 1968, it was broadened greatly in the landmark case of *SEC v. Texas Gulf Sulphur*. The case applied the insider-trading restrictions, invented out of whole cloth in *Cady Roberts*, to all corporate insiders and not just to brokers cheating on a cartel. The agency was, of course, extending its own powers, but more seems to have been involved in the case. The SEC claimed to be leveling the playing field and making information equally available to all investors. But with the communications technology available in 1968, there simply was no way to guarantee that new information could be available to everyone simultaneously. Someone did benefit from the holding, but who?

FINDING THE BENEFICIARIES

To answer that question, we must determine who would have the crucial first access to new corporate information after insiders were prevented from trading on it. In their superb 1987 academic article "Regulation on Demand: A Private Interest Model, with an Application to Insider Trading Regulation," professors David Haddock and Jonathan Macey made that determination. "Market professionals," including financial analysts, occupied the "second place in line" and, indeed, led the charge to have corporate insiders prevented from trading first.

In time, the SEC, with an assist from the U.S. Supreme Court, expressly condoned disclosures of unpublished information to select analysts and other financial professionals. Such private disclosures often involved hints or suggestions about current earnings or other developments that amounted to valuable inside information. The SEC argued that the selective disclosure system was consistent with its "full disclosure" philosophy because it caused the new information to be disseminated widely. Further, the SEC argued, the practice was harmless because the selective disclosure could not violate a fiduciary duty and because the informants were not allowed to receive a benefit in return for the disclosures to the analysts.

But it is extremely unlikely that financially sophisticated recipients of valuable information merely circulated it willy-nilly to the wide world of investors, or that they would not find some way to repay their sources of valuable information — perhaps with helpful "buy" recommendations or information from other companies at another time. The SEC thus never stopped insider trading; it merely changed the identity of those who traded on valuable undisclosed information.

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REGULATION FD

Then a funny thing happened. In October of 2000, the SEC adopted Regulation FD ("fair disclosure"), which reversed the previous rule and required that all future announcements of "material" information be made public before or at the same time that disclosure was made to any financial analyst. Corporate officials could no longer pick and choose the persons to whom they would make valuable disclosures.

That somewhat startling development was accepted by the media as representing a new front in the war on insider trading. They failed to notice that it did not take place until nearly 40 years after the war on insider trading was declared, or that the SEC was now turning on a group it had protected and benefited over its 67-year history.

So why did the SEC adopt Regulation FD? The answer to that lies in cost reductions and increased competition attributable to new technology. Recent revolutionary developments in communications technology, particularly the Internet, now offer vastly more efficient ways for investors to receive information. Financial news that not so long ago reached Main Street on the six o'clock news now passes almost instantaneously through media websites, financial news "chat" rooms, live Internet broadcasts of meetings with analysts, and, importantly, companies' direct use of the Internet to communicate with their investors.

Those technological developments are especially useful to the analysts who had not been favored with advanced disclosures, particularly those who worked exclusively for investment funds. Those analysts were never in a good position to do anything for the disclosing corporations, and they tended to favor Regulation FD. Naturally, the economic returns to the previously preferred analysts fell dramatically when the SEC could no longer protect their monopoly of information-gathering and dissemination. The rents that used to be available to fuel political support began to disappear.

We have already seen that the SEC has a history of abandoning redistributive policies only after changes in the market have diminished the rents produced by those policies. And so it is with Regulation FD; for all the clamor it created, it is merely another exercise by the SEC in recognizing *fait accompli*.

Advances in information technology have permanently changed the function of financial analysts in the dissemination of new information, giving companies less and less reason to play disclosure games. Securities markets are more liquid and efficient than ever. With newer technology on the horizon, we are nearing the previously unimaginable ideal of contemporaneous and almost instantaneous receipt of information by the mass of dispersed investors. The SEC should get no credit for those wonderful new developments. R