

INSIDER TRADING: IN SEARCH OF DEFINITIONAL CLARIFICATION

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I. Introduction / Literature Review

A person who is only a beginner at investigating what is happening in the stock markets has already heard the term “insider trading.” An ultra-simple definition of the term could easily be: “Purchasing or selling shares of a corporation’s stocks by an insider of that corporation.”

But very quickly we can enlarge upon - and complicate - that definition by indicating that such a purchaser or seller could have the advantage of additional (and **secret**) knowledge regarding the stock. As we shall see in the pages to follow, such **secret** knowledge may cause an insider to *violate certain rules* set by the Securities and Exchange Commission.

The pages to follow are dedicated to bringing clarification to insider trading - of both the *legal* and *illegal* types. And unfortunately we shall experience that numerous writers on the subject make little or no effort to differentiate between the *legal* and *illegal*.

II. Some Mass Media Treatment Of Insider Trading

Usually, when an American encounters the term “insider trading,” it comes to them through the mass media. Here are some examples.

Warning to the reader! Each of these four reports commits improper use of the term “insider trading!”

The internationally-respected news service *Reuters* on November 18, 2003 reported on the fate of Martha Stewart friend Samuel Waksal, founder of ill-fated ImClone Systems: “Waksal is currently serving a seven-year term for insider trading in his own company” (Charges). A year and a half later, Larry Neumeister of *The New York Sun* reported:

Two friends of jailed ImClone Systems founder and former chief executive officer Samuel Waksal were arrested yesterday on insider trading charges, prosecutors said (Neumeister)

Even within *The Concise Encyclopedia of Economics*, David Haddock has written:

Since the depths of the Great Depression, the Securities and Exchange Commission (SEC) has tried to prevent insider trading in U.S. securities markets (Haddock).

Even our nation’s leading business periodical, *The Wall Street Journal*, joins the club with a

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story by a team of its reporters for the issue of May 9, 2007:

Yesterday, the Securities and Exchange Commission filed a lawsuit against Kan King Wong and his wife, Charlotte Ka On Wong Lueng, in U.S. District Court in Manhattan, charging them with insider trading in connection with their purchases of 415,000 Dow Jones shares (Scannell, *et al.*).

The concept has been introduced; let's examine it.

III. Mini-Analysis Of "Insider Trading"

Each of the preceding reports, authored by responsible journalists, is equivalent to the following statement by a driver on a busy Interstate highway: "A state trooper stopped me and gave me a ticket for **driving!**"

For driving? There is nothing illegal about **driving!** However, driving is just as in the case of *insider trading* can indeed be done in an *illegal* manner. Even Webster's 1988 Dictionary has a hard time separating *fully legitimate* insider trading from *illegal* insider trading: "Insider trading ... the buying or selling of a company's stock by one who has access to information not made public: trading on such information may be illegal" (Webster's, p. 699). The current authors would counsel Webster's: "Work on that definition!"

Flagrant Display Of Not Understanding The Term

It is easily understood that a journalist far, far removed from Wall Street could slip up and misuse our key term. But there is indeed surprise when a writer closely watching nationally-important transactions makes that very same slip-up! Especially surprising when the writer's publication specializes in *business!* Credit such a slip-up to Paul Davies of *The Wall Street Journal*. Here's a look. Not even the headline writer's words could rescue Paul Davies: "Goldman Ex-Analyst Is Fifth to Plead Guilty in Broad Insider-Trading Scheme."

Here are short excerpts from the Davies article under that headline for August 29, 2007:

A former Goldman Sachs Group Inc. analyst pleaded guilty to his role in an insider-trading scheme that was hatched in a Russian day spa and grew to include more than a dozen conspirators in the U.S., Germany and Croatia. The scandal caught the attention of Wall Street and prompted investigators to intensify efforts to root out insider trading, with more cases said to be under investigation.... Eugene Plotkin, a Russian-born Harvard graduate and onetime competitive ballroom dancer, pleaded guilty to conspiracy and eight counts of insider trading.... Mr. [Stanislav] Shpigelman pleaded guilty last year to insider trading and was sentenced in January to 37 months in prison (Davies)

From a strictly **legal** standpoint, there is no crime mentioned in the preceding excerpt: insider trading is a legal stockholder activity. And that passage (with its headline) has committed

six typographical errors. Very clearly, for accuracy to prevail, the term “illegal” should precede each of those six mentions.

Who Is An Insider?

Very clearly, David D. Glass is an “insider” at Wal-Mart. He was Chief Finance Officer there from 1976 to 1984, Chief Operating Officer 1984 to 1988, CEO from 1988 to 2000, and as of last report was still a member of the Board. Glass owns \$67.2 million in Wal-Mart stock (*Wal-Mart Watch*), and there are reports from time to time of his buying or selling Wal-Mart stock. Yes indeed, Glass would definitely be defined as an “insider.”

His “insider trading” especially made the news in March of 2000 when Kevin Connoley wrote the following for *Missourinet*:

Where do you get 96 million dollars to buy a baseball team? The Kansas City Star reports that David Glass will sell nearly 40 percent of his Wal-Mart stock to raise the money. Glass has filed with the Securities and Exchange Commission to sell 2-million shares, valued at about 111-million dollars. The transaction will leave Glass with about 3 million shares of Wal-Mart stock (Connoley).

So far as the current authors can determine, Glass has never served any prison time whatsoever, not for *illegal* insider trading or for any other charge! Remember from a previous page, ImClone Systems founder Samuel Waksal is *in prison* for seven years!

As a person searches for a definition of a corporation’s “insider,” a definition that frequently comes up is: member of management, member of the board of directors, or owner of at least 10 percent of the stock of the company. However, the current study acquired a much more simple definition from the *official website* of the *Securities and Exchange Commission*, or SEC:

The legal version is when corporate insiders - officers, directors, and employees - buy and sell stock in their own companies. When corporate insiders trade in their own securities, they must report their trades to the SEC (“Insider Trading,” available on the Internet at www.sec.gov/answers/insider.htm).

Note that sentence: “When corporate insiders trade in their own securities, they must report their trades to the SEC” (*Ibid.*). We look now at a high-level “corporate insider” who followed completely that instruction from the SEC.

Lee Scott Buys Shares of His Firm’s Common Stock

For its issue of January 9, 2007, *The Morning News* of Northwest Arkansas furnished this report for its readers:

Lee Scott, president and CEO of Wal-Mart Stores Inc., picked up almost \$1.5 million this week when he sold more than 30,000 shares of Wal-Mart shares [somewhat unique wording from *The Morning News*]. In two separate transactions filed Friday with the

U.S. Securities [and] Exchange Commission, Scott sold 31,544 shares of [Wal-Mart] common stock at \$47.39 and another 594 shares at the same price to pay taxes on the 31,544 shares sold (Scott Sells).

The current authors add mathematical accuracy by stating that selling 31,544 shares at \$47.39 per share would result in proceeds of the sale reaching \$1,494,870.10 - wisely rounded off by *The Morning News* at \$1.5 million. The attention to tax considerations involved Scott selling an additional 594 shares at the same price of \$47.39 per share, netting Scott \$28,149.66 to pay the appropriate taxes. And it is proudly noted in *The Morning News* version that Scott filed the two “separate transactions” with the Securities and Exchange Commission.

The narrative which you have just read describes a major case of *insider trading*! And the authors proudly note that the action was **perfectly legal**!

In certain situations, however, the temptation for an insider to engage in an *illegal* form of insider trading can be *overwhelming*! Let’s create such a fictional situation.

An Attempt At An Example Of Doing It Illegally

Here is a *fictional* example. *Fictional* because to describe a **true** case and make *errors* in the *presentation* of it could possibly result in deep legal difficulties for such an author.

Bulldog Chemicals, Incorporated is confident that it has at last produced a simple medication that can thankfully eradicate the HIV virus among millions of children in Sub-Saharan Africa. What a blessing, a blessing reported in news reports around the globe. However, the World Health Organization (WHO) notifies Bulldog Chemicals - very secretly for the moment - that the new medication has no impact whatsoever! Such word becoming public *right now* could cause a catastrophic drop in share price on Bulldog Chemicals’ millions of shares of common stock traded via the New York Stock Exchange (NYSE). As might be easily guessed, Bulldog Chemicals has previously publicized the “blessed healing power” of its new drug. Price per share of Bulldog Chemicals common stock has shot up considerably! Immediately, the small circle of Bulldog Chemicals officers and the few holders of large amounts of Bulldog Chemicals stock - call them all “*insiders*” - sell their shares as quickly as they can at the NYSE.

Members of the general investing public make no such move. They know of no good reason to sell Bulldog Chemicals stock!

Those insiders, however, escape *financially* from a tragic loss in the value of their stock holdings. But they will soon face charges of engaging in a kind of insider trading that is clearly **illegal**!

Documenting Further Public Confusion

Just as the American press gives ample evidence of not understanding “insider trading,” Great Britain’s *The Economist* falls into the same trap. In its issue of May 15, 2007, there is a

reference to “Ivan Boesky, an arbitrageur who went to jail for insider trading” (Greed is still good).

The Economist of May 26, 2006 treats America’s Enron scandal and tragedy, by referring to Kenneth Lay and Jeffrey Skilling in this manner:

Mr Lay was found guilty by the jury of six counts of conspiracy and fraud and Mr Skilling on 18 counts but was acquitted on all but one charge of insider trading (The fraudsters).

Even Great Britain’s respected *The Economist* worded the sentence improperly.

A scandal in Croatia was treated by *The Economist* on June 19, 2007:

The Croatian authorities on June 16th announced the arrest of six officials from the Croatia Privatisation Fund (HPF)... The officials are suspected of accepting bribes; selling state firms without competitive tenders, usually at a large discount; real estate fraud; and insider trading.

Here at home, the Martha Stewart case really became legally complicated. Harry Browne, writing humorously for *LewRockwell.com*, enjoyed joking about her case, which involved selling - just in time - ImClone Systems stock. Allegedly she had some inside information but was not an ImClone insider. Here’s how Browne treated it:

In the first place, the law does *not* say that insider trading is a crime. And she wasn’t indicted for insider trading.... Thus she was convicted on three counts of lying about something that isn’t a crime and that she wasn’t charged with doing. If the government can’t charge her with insider trading, what difference does it make whether she *lied* about insider trading? (Browne).

IV. Expansion Of The Term “Insider”

Earlier in this research effort, there was quoted the following quick definition of “insiders” from the Securities and Exchange Commission:

The legal version is when corporate insiders - officers, directors, and employees - buy and sell stock in their own companies. When corporate insiders trade in their own securities, they must report their trades to the SEC (“Insider Trading,” available on the Internet at www.sec.gov/answers/insider.htm).

Such insiders - officers, directors, and employees - are indeed **not** to use very special inside information of the firm as a means to profit before the general public knows some indeed bad news of the firm. As of summer 2007, F. John Reh of *About.com*, a part of *The New York Times* company, spread the word that the SEC has a broader definition of an insider. Here’s how Reh explained it:

The SEC includes in its definition of insiders those who have “temporary” or “constructive” access to the material information. If the President of a company tells you that the company’s best hope for a breakthrough product isn’t going to get regulatory approval, you are now every bit as much an insider as he is, with respect to that information. It is illegal for him to trade based on that knowledge before it becomes public knowledge. It is equally illegal for you to do so because you are now a “temporary insider.” This remains true regardless of how many times the information is passed. If the president tells his barber, who tells her [?] baby sitter, who tells her doctor, who tells you, [then] the barber, baby sitter, doctor and you are all “temporary insiders” (Reh).

Let’s expand upon that idea which F. John Reh picked up from the SEC. Sometimes by carefully watching a firm and its personnel in action, one can produce a look at the inside mood B and perhaps acquire some *inside* information. The next section contains an example of this.

Things May Be Developing Inside

For *The Wall Street Journal* edition of August 8, 2007, Nicolas Brulliard attempted to peek into the windows of the Xerox Corporation. His opening paragraph went this way:

Three of Xerox Corporation’s top executives recently made a move seldom duplicated at the maker of printers and copiers: They bought some of their company’s stock (Brulliard).

Author Brulliard quoted several people who saw nothing unusual in that move by some top executives. He then gave space to another view:

However, Jack Adamo editor of *Insiders Plus*, a weekly investment newsletter that follows insider activity, said he is suspicious when several executives buy their company’s stock at the same time. The unanimity among Xerox’s top executives suggests that they acted in concert and that their actions may have been more of a public relations move in the wake of the drop of the stock price (*Ibid.*).

It was clear that the company did not want to provide any discussion of the *Journal* story: “A Xerox spokesman declined to comment and said all three executives were unavailable for comment” (*Ibid.*). At least for the moment, the company’s attitude seemed to be: “This is *inside* information, and it will remain *inside*.”

The Classic Case of R. Foster Winans

Very clearly, we’ve seen that the illegal side of insider trading involves someone making use of information not available to the general public. From 1982 to 1984, a journalist by the name of R. Foster Winans wrote a column titled “Heard on the Street” for *The Wall Street Journal*. According to *Wikipedia, the free encyclopedia*, here’s how Winans entered the insider arena:

During a well-publicized crackdown on insider trading that would later snare some of the hottest traders on Wall Street (such as Michael Milken and Ivan Boesky), [Winans] was indicted by then-U.S. Attorney Rudolph Giuliani and convicted in 1985 of violating Federal law by leaking advance word of the contents of his columns to a stockbroker, Peter N. Brant, at Kidder, Peabody & Co., an old-line brokerage firm (R. Foster Winans).

Said another way, Winans would have extremely important information on major American firms and - prior to the appearing of his column in *The Wall Street Journal* - he would have a broker make moves to greatly help some of Winans' friends. Certain of these moves were **very helpful** to Winans' buddies - to a total tune of an estimated \$1,000,000! **His** cut was only \$31,000. He served about eight months in prison and paid a \$5,000 fine (Where are they now?)

As for the Winans cut of \$31,000, *Time* writer William A. Henry III explained it in the following manner. Note that Henry mentions two other brokers employed at the time by Kidder Peabody:

But in May [1984] the SEC charged in a civil suit that two stockbrokers who shared in the scheme, David Brant and Kenneth Felis, both then employed by Kidder Peabody, paid Winans \$31,000 disguised as interior-decoration fees to his New York City roommate, David Carpenter (Henry).

The U.S. Supreme Court spoke in a manner completely harmonious with the mood of this current study: there is still misunderstanding regarding insider trading! And that misunderstanding has indeed seeped into the Supreme Court. As Winans wrote in a *New York Times* op-ed, when the U.S. Supreme Court ruled on his case in 1987, the Justices **agreed** that he had defrauded the *Journal* but **split** on whether it constituted insider trading - legal or **illegal!** (Where are they now? - **bold** emphasis by the current authors).

V. Conclusion

Like so many human activities, *insider trading* can be carried out in a legal manner as well as in an illegal way. The current study has attempted to show both ways of *insider trading*. Further, the study has clearly established that there are indeed respectable journalists who regularly - by error - give the term a strictly criminal meaning. May we all learn to engage in this activity in a perfectly legal manner. May we also encourage appropriate officials to punish and eliminate those who use the technique in an illegal manner.

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