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Rethinking Insider Trading Regulation

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The question of distinguishing between the informational advantages insiders and outsiders may and may not legitimately exploit in trading in the financial markets is perennial: is securities regulation about achieving a level playing field for investors or about imposing sanctions for certain fiduciary and fiduciary-like breaches of duty which go beyond traditional remedies for such breaches. The Second Circuit's decision in US v Newman emphasizes the fiduciary duty component of liability: at least in a criminal case involving tipping by insiders "the Government must prove beyond a reasonable doubt that the tippee knew that an insider disclosed confidential information and that he did so in exchange for a personal benefit."

In these papers Yesha Yadav focuses on two specific problem areas in insider trading regulation, relating to trading in credit default swaps (CDS) by lenders and "structural" trading using a combination of preferential access to information and locational advantages. Both examples present arguments for a rethinking of how insider trading regulation should address the realities of modern, complex, financial markets.

The contexts of the two papers differ. With respect to *Insider Trading in Derivatives Markets*, Professor Yadav is addressing a context in which regulators have decided to extend insider trading prohibitions to derivative markets. In *Structural Insider Trading*, on the other hand, Professor Yadav identifies "cracks in regulation" (p. 4).

Congress extended the prohibition of insider trading to transactions in swaps and futures in the Dodd-Frank Act in 2010 and the CFTC implemented the prohibition in rules issued in 2011. By 2010 concerns about the risk of insider trading in credit derivatives was not exclusively a US domestic concern: the Joint Forum of transnational standard setters for financial regulation had identified this as an issue in 2008. But Professor Yadav persuasively argues that trading on insider information in CDSs may improve the informational efficiency of the securities markets, benefiting shareholders. Lenders with access to inside information about their borrowers have incentives to transfer the credit risk associated with their lending, and their ability to hedge risk encourages lending, which benefits shareholders "at least in the near term."(p. 416) The story is not all positive, however, as lender activity with respect to CDSs may harm shareholders, and shareholders have limited capacity to monitor lenders (p. 417). Lenders may transact in ways that over-emphasize bad news (p. 419).

Professor Yadav suggests that lenders and borrowers might be able to contract around insider trading liability to fix the doctrinal problem. However, she notes that this fix might not work because corporate debtors suffer from a weak bargaining position and monitoring a lender's compliance with the terms of a contract would be challenging. As usual in the insider trading context disclosure could play a role, although a borrower would have limited options to respond to a lender's disclosed proposed CDS trades (p. 428). Insider CDS trading raises more general questions about the fit between established doctrine and the realities of the markets: the "tension between law and reality…dismantles long-held assumptions in theory."

Structural Insider Trading similarly focuses on realities of the financial markets to challenge established assumptions about insider trading law. High speed algorithmic trading strategies combined with geographic proximity to trading venues provides an informational edge (p5) (of course, this development, together with the complex harmonization-differentiation picture of financial regulation also challenges some of the thinking about the decreasing relevance of geography to finance). The informational edge creates a tension between "speed in trading and the policy goal of ensuring broad and equal access to information."(p 5) Professor Yadav argues:

> structural insider trading inverts the traditional policy priority underpinning the prohibition against insider trading. Under Rule 10b-5, liability is justified as a way to protect insiders despite negative effects on market efficiency. By contrast, structural insider trading privileges market efficiency over investor protection, in giving structural insiders the ability to trade on soon-to-be public information despite costs to investors-at-large.

These are two papers which demonstrate very clearly and usefully a need to rethink one area of financial regulation for a complex, evolving, market reality.

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