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# The Regulation of Insider Trading

Dennis W. Carlton\* and Daniel R. Fischel\*\*

Imagine two firms, A and B, which are identical in all respects except that, in its charter, firm A prohibits the trading of its shares based on inside (nonpublic) information. The firm requires insiders (employees) to report their trades, which a special committee or an independent accounting firm then checks to ensure compliance with the charter provision. Firm B, by contrast, neither prohibits insider trading nor requires reporting. Insiders openly trade shares of firm B and regularly earn positive abnormal returns. In competitive capital markets, which charter provision will survive?

Despite the deceptive simplicity of this question, it has no obvious answer.<sup>1</sup> The consensus, to the extent that any exists, appears to be that firm A's charter will survive because it eliminates various per-

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1. The literature on insider trading is too voluminous to cite in detail. The starting point for anyone interested in the subject is Henry Manne's brilliant book, *Insider Trading and the Stock Market*, which argues that insider trading is an efficient way to compensate entrepreneurs. See H. MANNE, *INSIDER TRADING AND THE STOCK MARKET passim* (1966) [hereinafter cited as H. MANNE, *INSIDER TRADING AND THE STOCK MARKET*]; see also Manne, *Economic Aspects of Required Disclosure Under Federal Securities Laws*, in *WALL STREET IN TRANSITION: THE EMERGING SYSTEM AND ITS IMPACT ON THE ECONOMY* 21 (1974); Manne, *Insider Trading and the Law Professors*, 23 *VAND. L. REV.* 547 (1970).

For more recent work, see Anderson, *Fraud, Fiduciaries, and Insider Trading*, 10 *HOFSTRA L. REV.* 341 (1982); Brudney, *Insiders, Outsiders, and Informational Advantages under the Federal Securities Laws*, 93 *HARV. L. REV.* 322 (1979); Dooley, *Enforcement of Insider Trading Restrictions*, 66 *VA. L. REV.* 1 (1980); Easterbrook, *Insider Trading, Secret Agents, Evidentiary Privileges, and the Production of Information*, 1981 *SUP. CT. REV.* 309 [hereinafter cited as Easterbrook, *Insider Trading*]; Easterbrook, *Insider Trading as an Agency Problem*, in *THE AGENCY RELATIONSHIP* — (J. Pratt & R. Zeckhauser eds.) (forthcoming); Haft, *The Effect of Insider Trading Rules on the Internal Efficiency of the Large Corporation*, 80 *MICH. L. REV.* 1051 (1982); Heller, Chiarella, *SEC Rule 14e-3, and Dirks: "Fairness" Versus Economic Theory*, 37 *BUS. LAW.* 517 (1982); Karjala, *Statutory Regulation of Insider Trading in Impersonal Markets*, 1982 *DUKE L.J.* 627; Levmore, *Securities and Secrets: Insider Trading and the Law of Contracts*, 68 *VA. L. REV.* 117 (1982); Scott, *Insider Trading: Rule 10b-5, Disclosure and Corporate Privacy*, 9 *J. LEGAL STUD.* 801 (1980); Wang, *Trading on Material Nonpublic Information On Impersonal Stock Markets: Who is Harmed, and Who Can Sue Whom Under SEC Rule 10b-5?*, 54 *S. CAL. L. REV.* 1217 (1981).

Economists also have become increasingly interested in insider trading. See, e.g., Ross, *Disclosure Regulation in Financial Markets: Implications of Modern Finance Theory and Signaling Theory*, in *ISSUES IN FINANCIAL REGULATION* 177 (F. Edwards ed. 1979) [hereinafter cited as Ross, *Disclosure Regulation*]; Ross, *The Determination of Financial Structure: The Incentive-Signalling*

ceived harmful effects of insider trading. Thus, investors would pay less for shares in B. The managers of B, in order to maximize the value of B shares, would have to adopt a similar charter provision.

As for these harmful effects, many believe that insider trading is "unfair" and undermines public confidence in capital markets.<sup>2</sup> Other critics have argued that insider trading creates perverse incentives by allowing corporate managers to profit on bad news as well as good,<sup>3</sup> encourages managers to invest in risky projects,<sup>4</sup> impedes corporate decisionmaking,<sup>5</sup> and tempts managers to delay public disclosure of valuable information.<sup>6</sup> Some also have argued that insider trading is an inefficient compensation scheme because, in effect, it compensates risk-averse managers with a benefit akin to lottery tickets.<sup>7</sup> Still others have claimed that insider trading allows insiders to divert part of the firm's earnings that would otherwise go to shareholders and therefore raises the firm's cost of capital.<sup>8</sup> Under this "insider trading is harmful to investors" hypothesis, competitive capital markets would force firm B to prohibit insider trading.

The difficulty with this hypothesis is that it appears to be contradicted by the actions of firms. Although no one has conducted rigorous empirical research in this area, it is generally believed that firms have made little, if any, attempt to prohibit insider trading, at least until very recently and then perhaps only as a response to regulation.<sup>9</sup> Today the area is federally regulated,<sup>10</sup> but the federal insider

*Approach*, 8 BELL J. ECON. 23 (1977); Mendelson, Book Review, 117 U. PA. L. REV. 470 (1969); R. Dye, Inside-Trading and Incentives (Feb. 1983) (unpublished working paper, University of Chicago Graduate School of Business) (on file with *Stanford Law Review*); R. Leftwich & R. Verrecchia, Insider Trading and Managers' Choice Among Risky Projects (Aug. 1981) (CRSP Working Paper No. 63, University of Chicago, Graduate School of Business) (on file with *Stanford Law Review*).

2. See, e.g., Brudney, *supra* note 1, at 343-46; Karjala, *supra* note 1, at 629; Levmore, *supra* note 1, at 124-25; Schotland, *Unsafe at Any Price: A Reply to Manne*, Insider Trading and the Stock Market, 53 VA. L. REV. 1425, 1440-42 (1967).

3. See, e.g., Levmore, *supra* note 1, at 149; Mendelson, *supra* note 1, at 489-90; Schotland, *supra* note 2, at 1451.

4. Easterbrook, *Insider Trading*, *supra* note 1, at 332; R. Leftwich & R. Verrecchia, *supra* note 1.

5. Haft, *supra* note 1, at 1053-64.

6. See, e.g., Mendelson, *supra* note 1, at 489; Schotland, *supra* note 2, at 1448-49.

7. Easterbrook, *Insider Trading*, *supra* note 1, at 332; Scott, *supra* note 1, at 808.

8. Brudney, *supra* note 1, at 356; Mendelson, *supra* note 1, at 477-78.

9. See Dooley, *supra* note 1, at 44-45; Easterbrook, *Insider Trading*, *supra* note 1, at 333; cf. H. MANNE, INSIDER TRADING AND THE STOCK MARKET, *supra* note 1, at 1-2 (popular attitudes towards corporate morality did not until recently condemn insider trading); Wang, *supra* note 1, at 1245 (reasons why businessmen might not consider insider trading immoral). This general belief does not extend to specialized areas such as law firms or corporate printers.

10. Section 16 of the Securities Exchange Act of 1934, 15 U.S.C. § 78p (1976), was the

trading prohibitions are limited, have rarely been enforced, and have had little observable effect on insider trading.<sup>11</sup> Indeed, numerous empirical studies have demonstrated that insider trading is widespread and is highly profitable—insiders systematically outperform the market.<sup>12</sup> Critics of insider trading have offered no explanation for why firms have made so little attempt to prohibit insider trading.

Critics of insider trading also should predict that insiders who outperform the market reduce their compensation in labor markets. Just as a manager who is known to shirk or to make poor investment decisions will consequently command lower compensation, so should a manager who is known to trade on inside information and earn abnormal positive returns, as revealed by his reported trades.<sup>13</sup> Yet no evidence even suggests that managers who report profitable trades thereby decrease the value of their human capital.

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first attempt to regulate insider trading. Section 16 applies only to directors, officers, and large shareholders. It requires these individuals to report all trading activity in the stock (or other financial instruments, like options) of their company, prohibits short selling, and requires disgorgement of any profit that results from holding a position less than 6 months. The prohibition was extended in 1968 by judicial construction of § 10(b) of the 1934 Act, 15 U.S.C. § 78j(b) (1976), to restrict individuals in possession of "material" information from trading. See note 90 *infra*. An earlier administrative decision of the SEC, Cady, Roberts & Co., 40 S.E.C. 907 (1961), was an important precursor to the 1968 extension of the laws against insider trading. We discuss the federal regulation of insider trading in more detail at notes 90–114 *infra* and accompanying text.

11. For an analysis of the lack of enforcement of insider trading prohibitions, see generally Dooley, *supra* note 1. This relative absence of enforcement may be changing with the recent crusade of the SEC against insider trading. It is too early to analyze this issue. On the limited nature of the prohibition, see note 10 *supra*; text accompanying notes 17–19 *infra*.

12. For empirical studies demonstrating that insiders systematically outperform the market, see Baesel & Stein, *The Value of Information: Inferences from the Profitability of Insider Trading*, 14 J. FIN. & QUANTITATIVE ANALYSIS 553 (1979); Finnerty, *Insiders and Market Efficiency*, 31 J. FIN. 1141 (1976); Jaffe, *The Effect of Regulation Changes on Insider Trading*, 5 BELL J. ECON. & MGMT. SCI. 93 (1974); Jaffe, *Special Information and Insider Trading*, 47 J. BUS. 410 (1974); Keown & Pinkerton, *Merger Announcements and Insider Trading Activity: An Empirical Investigation*, 36 J. FIN. 855 (1981); Lorie & Niederhoffer, *Predictive and Statistical Properties of Insider Trading*, 11 J.L. & ECON. 35 (1968); Penman, *Insider Trading and the Dissemination of Firms' Forecast Information*, 55 J. BUS. 479 (1982).

Because insider trading has continued to thrive despite regulation, firms still have incentives to minimize the practice if prohibition were in the best interests of investors. The absence of widespread private restrictive measures even today beyond what is required by regulation is therefore difficult to reconcile with the general perception that insider trading is harmful to investors.

13. This should follow even if the trades are not illegal under § 10(b) or § 16(b). The arguments of the critics of insider trading are dependent on the ability of insiders to earn abnormal positive returns, not on whether the trades are illegal. On the distinction between the legal and economic definitions of insider trading, see note 17 *infra* and accompanying text.

Also puzzling is the common law which, in the main, permitted insider trading.<sup>14</sup> Because capital is highly mobile, firms, in order to attract investors, have strong incentives to incorporate in states that have efficient corporation laws.<sup>15</sup> Because incorporations are profitable to the state, the states in turn have strong incentives to provide a set of legal rules that maximize shareholders' welfare. If eliminating insider trading produced gains, states that prohibit insider trading would have a comparative advantage over other states, and firms that incorporated in such states would have a comparative advantage over other firms. Yet no evidence suggests that this has occurred.

Similarly, insider trading in the capital markets of many other countries historically has been subject either to regulations that have not been enforced or to no regulation at all.<sup>16</sup> This phenomenon, like the absence of domestic private and state prohibitions, suggests that the question of the desirability of insider trading is far more complex than commonly assumed.

Finally, insider trading in this country, despite the widespread perception to the contrary, is generally permitted. A fundamental difference exists between the legal and economic definitions of insider trading. Insider trading in an economic sense is trading by parties who are better informed than their trading partners. Thus, insider trading in an economic sense includes all trades where information is asymmetric. This definition includes all trades, whether or not in securities, where one of the parties has superior information. By contrast, federal law has focused on purchases or sales by certain insiders within a 6-month period or on trading on the basis of "material"

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14. The common law rules on insider trading are discussed in *Freeman v. Decio*, 584 F.2d 186, 191-95 (7th Cir. 1978); see also H. MANNE, *INSIDER TRADING AND THE STOCK MARKET*, *supra* note 1, at 17-26 (discussing the evolution of common law rules); Conant, *Duties of Disclosure of Corporate Insiders Who Purchase Shares*, 46 CORNELL L.Q. 53, 54-63 (1960).

15. For discussion of the significance of state corporation laws, see generally R. WINTER, *GOVERNMENT AND THE CORPORATION* (1978); Easterbrook & Fischel, *Voting in Corporate Law*, 26 J.L. & ECON. 395 (1983); Fischel, *The "Race to the Bottom" Revisited: Reflections on Recent Developments in Delaware's Corporation Law*, 76 NW. U.L. REV. 913 (1982).

16. See generally B. RIDER & H. FRENCH, *THE REGULATION OF INSIDER TRADING* (1979). In Japan, for example, insider trading is considered proper, and there has never been a reported case under the limited insider trading prohibition currently in effect. *Id.* at 361. Hong Kong first regulated insider trading in 1974, but this regulation has been repealed. *Id.* at 328. France has a narrow insider trading prohibition, but again, the practice is not considered immoral and "the total number of suits and administrative sanctions is nearly nil." *Id.* at 238. In the United Kingdom, there historically has been no regulation of insider trading, but the trend is towards regulation. *Id.* at 146, 445. This trend is too recent to analyze the level of enforcement.

information by a broader, more amorphous group of insiders or their tippees. Insider trading in an economic sense need not be illegal.<sup>17</sup> The law never has attempted to prohibit all trading by knowledgeable insiders.

For purposes of analyzing whether insider trading is beneficial or detrimental, nothing turns on whether a particular trade is illegal. In assessing the arguments for and against insider trading, therefore, we will focus on trading by managers or other employees in securities of their own firms based on superior knowledge regardless of whether the trade is illegal. We emphasize, however, that the arguments for and against insider trading may apply equally to trading by others.<sup>18</sup>

We attempt in this article to analyze critically the arguments in favor of prohibiting insider trading and to suggest why allowing the practice may be an efficient way to compensate corporate managers.<sup>19</sup> Part I demonstrates that the insider trading debate is really a debate about whether the firm, as a matter of contract, should be able to allocate property rights in valuable information to managers or to investors. We argue that the parties' self-interest will lead them to reach by private agreement the optimal allocation of what is simply one element of a compensation arrangement. We discuss in Part II several incentive and information effects which suggest that there may be gains from allocating property rights in valuable information to managers as opposed to investors. These gains may explain the lack of pervasive private, common law, and foreign and domestic restraints on insider trading. Part III analyzes some of the numerous objections to insider trading. The various legal rules regulating insider trading are critically analyzed in Part IV. Part V is a conclusion.

## I. INSIDER TRADING AND THE COASE THEOREM

Critics of insider trading draw a sharp distinction between the proper legal response to insider trading and to other forms of managerial compensation. Salaries, bonuses, stock options, office size, vacation leave, secretarial support, and other terms of employment are all, it is generally assumed, properly left to private negotiation. Nobody would argue seriously that these terms and conditions of em-

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17. See notes 94-100 *infra* and accompanying text.

18. See texts accompanying notes 56-57, 75-76, 96-102 *infra*.

19. We confine our discussion to publicly traded corporations and do not discuss small closely-held corporations or partnerships. The principle-agent problems in the latter groups of firms are likely to differ substantially from those in large publicly held corporations.

ployment should be set by government regulation—that a federal agency, for example, should monitor the amount of leisure time taken by corporate managers. Most would agree that these decisions are better made through negotiations between firms and managers, given the constraints of capital, product, and labor markets as well as the market for corporate control.<sup>20</sup> Although the negotiation and enforcement of these employment agreements are costly, these costs are presumptively lower than would be the case if negotiation and enforcement were handled by government regulators who are undisciplined by markets.<sup>21</sup>

Precisely the opposite presumptions have been applied with respect to insider trading. Most believe that existing government regulation is necessary and should be extended; virtually no one has considered the possibility, let alone has argued, that private negotiations between a firm and its employees can most efficiently determine whether insiders should be allowed to profit by trading on inside information.<sup>22</sup>

Does whatever difference that exists between profits from trading in shares and other forms of compensation warrant such different legal responses? It is no answer to argue that insider trading is unfair, constitutes theft, destroys investors' confidence, or compensates inefficiently. These characterizations just as aptly describe a hypothetical compensation scheme whereby managers pay themselves huge salaries and consume unlimited perquisites, regardless of their productivity. Government need not prohibit this type of compensation agreement because, given competitive markets, firms will have strong incentives to avoid such a scheme. The identical argument applies to insider trading: If it is bad, firms that allow insider trading will be at a competitive disadvantage compared with firms that curtail insider

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20. These markets are discussed in more detail in Easterbrook & Fischel, *Corporate Control Transactions*, 91 YALE L.J. 698 (1982) [hereinafter cited as Easterbrook & Fischel, *Corporate Control Transactions*]; Easterbrook & Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161 (1981).

21. Government enforcement of employment terms is not without precedent. Criminal penalties for theft are perhaps the best example. But such penalties probably are designed primarily for cases involving strangers, where there is no pre-existing contractual relationship. In any event, the main issue concerning the regulation of insider trading is not whether there should be public enforcement of a private prohibition, but whether there should be public enforcement even if there is no private prohibition. On the relationship between the regulation of insider trading and the penalties for theft, see text accompanying note 105 *infra*.

22. Only Manne has even suggested this argument. See H. MANNE, INSIDER TRADING AND THE STOCK MARKET, *supra* note 1, at 138-41.

trading.<sup>23</sup>

Coase's famous insight is quite relevant in this regard.<sup>24</sup> Whether insider trading is beneficial depends on whether the property right in information is more valuable to the firm's managers or to the firm's investors. In either case, the parties can engage in a value-maximizing exchange by allocating the property right in information to its highest-valuing user. If the critics of insider trading are correct, therefore, both the firm's investors and the firm's insiders could profit by banning insider trading, thereby allocating the property right in information to the firm's investors.

It is important to recognize that this mutual incentive to allocate the property right in information to its highest-valuing user does not depend on actual negotiations between insiders and investors. As long as investors understand the possibility of insider trading, both share price and managers' compensation will be higher if the efficient allocation is reached than if it is not.<sup>25</sup>

The preceding discussion assumes, of course, that transaction costs will not interfere with the optimal allocation of property rights. While the costs of negotiating contracts banning insider trading in the employer-employee situation appear to be low, some have argued that the costs of enforcing such contracts are high.<sup>26</sup> Firms must encourage managers to own shares, the argument runs, to induce them to act in shareholders' best interests. Once having permitted share ownership by managers, the firm, because it cannot separate proper from improper trades, cannot adequately enforce a rule against insider trading. These high enforcement costs render firms unable to prohibit insider trading, even if doing so would benefit all parties.

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23. Given a sufficient amount of search by investors, firms will offer contract terms that investors desire even if a substantial percentage of other investors engage in no search. The shoppers, in effect, protect the nonshoppers. See Schwartz & Wilde, *Imperfect Information in Markets for Contract Terms: The Examples of Warranties and Security Interests*, — VA. L. REV. — (forthcoming Nov. 1983); Schwartz & Wilde, *Intervening in Markets on the Basis of Imperfect Information: A Legal and Economic Analysis*, 127 U. PA. L. REV. 630 (1979). In light of the constant efforts of investment analysts and other professional investors to outperform the market, it is obvious that the amount of search in securities markets is substantial.

24. Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1 (1960).

25. An analogy exists to the area of products liability, where firms have incentives to design products in a manner that minimizes the sum of production costs and consumers' expected accident losses. This suggests that regardless of legal liability rules, firms will reach efficient outcomes, as long as expected losses are known. See A. M. POLINSKY, AN INTRODUCTION TO LAW AND ECONOMICS 95-104 (1983); Hamada, *Liability Rules and Income Distribution in Product Liability*, 66 AM. ECON. REV. 228 (1976).

26. See, e.g., Easterbrook, *Insider Trading*, *supra* note 1, at 334.



The only practical method to ban insider trading, the argument concludes, is public enforcement with large penalties.

This argument fails to consider that firms need not be able to enforce contracts prohibiting insider trading perfectly to benefit from entering into such contracts, if such contracts were in the interest of investors. The costs of including provisions in the corporate charter or in employment contracts banning insider trading and requiring reporting of all transactions in the firm's securities would be minimal. And it is reasonable to assume that such provisions would deter some, if not most, insider trading, particularly if they required an audit of schedule D of the manager's tax return and imposed sanctions such as liquidated damages, termination of employment, and forfeiture of benefits.<sup>27</sup> True, managers still might be able to engage in some insider trading or to communicate valuable information to friends or relatives. But the relevant point is that the gains from incomplete enforcement—under the hypothesis that insider trading is harmful to investors—would outweigh the negligible costs of contracting. Thus, the apparent absence of widespread use of such contracts cannot be explained by the difficulty of obtaining perfect enforcement. Rather, this absence suggests that such contracts are not efficient.<sup>28</sup>

Moreover, the argument overstates the problems with private enforcement because it assumes that managers must own shares to be induced to act in shareholders' best interests. There is no reason, however, why this must be the case. The strategy, presumably, is to ensure that managers have a stake in the venture so that they will profit from good performance and lose from bad performance. But this incentive effect in no way depends on the actual ownership of shares. Firms are perfectly free to base compensation on share performance and thus create incentives for managers to increase the value of their firms even if managers own no shares.<sup>29</sup> If managers

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27. For discussion of the role of termination and forfeiture provisions in reducing the divergence of interest between managers and shareholders, see Lazear, *Why Is There Mandatory Retirement?*, 87 J. POL. ECON. 1261 (1979); Smith & Watts, *Incentive and Tax Effects of Executive Compensation Plans*, 7 AUSTR. J. MGMT. 139, 145-47 (1982).

28. An alternative explanation for the absence of such contracts is that a problem exists, but it is too small to worry about. If this were the case, of course, there would be no reason for federal regulation because there would be no significant problem to address.

29. See Diamond & Verrecchia, *Optimal Managerial Contracts and Equilibrium Security Prices*, 37 J. FIN. 275, 281-83 (1982). Contracts that base compensation on share performance would not be perfect substitutes for actual ownership of shares. First, the contract alternative raises the problem of forcing the manager to pay the firm for poor performance; a manager owning stock would suffer automatically when stock values drop. This problem increases as managers

are forbidden from owning shares, the problem of separating proper from improper trades disappears. Alternatively, firms could allow managers to own shares, but not trade them.<sup>30</sup> That firms generally do not eliminate insider trading by employing these alternative methods for controlling share ownership while linking managers' fortunes with those of the firm again suggests that the explanation for the absence of such prohibitions is that they are inefficient, not that they are unenforceable.<sup>31</sup>

The notion that the dispute concerning insider trading is really a dispute about which party more highly values a property right and that whatever bargain is reached can be enforced (albeit imperfectly) by the parties themselves undermines the case for regulatory prohibition of insider trading. Such a prohibition could be justified only if it were clear that the parties themselves had attempted to deter insider trading by contract and that the government had a comparative advantage in enforcing such contracts.<sup>32</sup> But the comparative advantage in enforcement is irrelevant without a showing that firms generally have attempted to limit insider trading by contract. Without such a showing, a regulatory prohibition will likely displace effi-

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approach retirement because it becomes increasingly difficult to adjust compensation for future periods. For a discussion of how pensions can be used as a solution to this problem for managers nearing retirement, see Lazear, *supra* note 27. On the other hand, the contract alternative directly ties total compensation to stock performance rather than depending on the fortuitous elements of the amount of share ownership or general market movements. Second, the contract alternative may affect the market for corporate control. In any control fight, including a proxy fight, one natural contestant is the managerial group. Thus, optimal managerial contracts would have to allow some provision for the purchase of shares during control fights.

30. For a discussion of how such contracts might be written, see Levmore, *supra* note 1, at 129-32. Restricted and phantom stock plans that are used by some firms as incentive devices have the effect of allowing the ownership but not the trading of shares. See Smith & Watts, *supra* note 27; see also Miller & Scholes, *Executive Compensation, Taxes and Incentives*, in FINANCIAL ECONOMICS: ESSAYS IN HONOR OF PAUL COOTNER 179 (W. Sharpe & C. Cootner eds. 1982); C. Smith & R. Watts, *The Structure of Executive Compensation Contracts and the Control of Management* 23-25 (April 7, 1983) (unpublished manuscript) (on file with *Stanford Law Review*).

31. It is not possible to argue that federal regulations have eliminated the incentives for firms to ban insider trading because such trading is still widespread and profitable. See notes 11-12 *supra* and accompanying text.

32. Whether the government actually has a comparative advantage in enforcing contracts prohibiting insider trading is far from clear. See Dooley, *supra* note 1, at 46 ("[P]rivate firms have a decided advantage over the government in terms of the certainty and costs of enforcement."). Resolution of this issue would require a great deal of evidence that currently does not exist. Our point is that even if we assume that the government does have a comparative advantage in enforcing an insider trading prohibition, this alone does not justify enactment of the prohibition itself nor of a prohibition that firms cannot opt out of. See text accompanying notes 105-06 *infra*.

cient private arrangements with inefficient regulatory solutions, much in the same way that regulation of salaries, bonuses, office size, leisure time, and all other terms of employment would be inefficient.

Our conclusion that a regulatory prohibition of insider trading (which would involve a substantial extension of existing regulations) is unwarranted has relied heavily on the apparent lack of widespread attempts by firms to prohibit insider trading. Insider trading in an economic sense continues to be widespread. (Curiously, the proponents of regulation have failed to cite any evidence of private prohibitions to support their contention that firms desire to ban insider trading.) Of course, the allocation of the property right in valuable information to managers might not be optimal in all circumstances for every firm. But even if some firms would attempt to ban insider trading in the absence of regulation, other firms should nonetheless be able to opt out of the regulations if they so desire. No justification exists for precluding firms from contracting around a regulatory prohibition of insider trading.

## II. WHY FIRMS MIGHT WANT TO ALLOCATE THE PROPERTY RIGHTS IN VALUABLE INFORMATION TO MANAGERS AS OPPOSED TO SHAREHOLDERS

Thus far, we have argued that firms and managers are able to allocate property rights in valuable information by private negotiation. In this section, we explain why the parties might choose to allocate these property rights to managers and thus allow insider trading. Because unambiguous welfare statements can be very difficult to make even in simple economic models involving uncertainty, to expect any analysis to prove that insider trading is solely harmful or solely beneficial is unrealistic. The desirability of insider trading is ultimately an empirical question. Nevertheless, analyzing how insider trading affects information transmission and shapes incentives will enable us to understand better the consequences of different allocations of the property rights in valuable information.

### A. *Information Effects*

The social gains from efficient capital markets are well known. The more accurately prices reflect information, the better prices guide capital investment in the economy. From the perspective of an individual firm, however, efficient capital markets are a public good, unless private, as opposed to social, gains accrue to the firm when the

prices of its own securities convey accurate information. Why, then, does a firm disclose information about itself?

One reason is that disclosure can reduce wasteful expenditures on search and reduce investor uncertainty about the firm. This may make the firm more valuable to investors. Investors expend resources to identify overvalued or undervalued securities until the next dollar they spend on information no longer produces an additional dollar of return.<sup>33</sup> If the firm can produce information about itself at the lowest cost, disclosure of information by the firm will save resources by reducing the amount of expenditures on search and will lead to less investor uncertainty about the firm.

A second reason is that disclosure of information by the firm also may enable the firm's current investors to sell their shares to outsiders at a higher price, on average. If the firm discloses no information, outsiders may assume the worst and discount the price they are willing to pay for shares by a factor that reflects their uncertainty. Because every firm has an incentive to distinguish itself from those firms about which the worst is true, so that outsiders will pay a higher price for its shares, information will be produced.<sup>34</sup>

Finally, accurately priced securities will enable firms to observe more accurately when corporate managers are successful. Thus, markets for managerial services and for corporate control will function more effectively.<sup>35</sup> Also, the better managers will signal their quality by their willingness to tie a higher proportion of their compensation to stock performance. Accurate prices then enable these managers to receive the rewards for their superior performance. For these reasons, shareholders would want managers to disclose information about the value of the firm.

Complete disclosure, however, would not be optimal. Disclosure is costly, and at some point the costs will outweigh the benefits of increased disclosure. Moreover, in some cases, disclosure might destroy the information's value. It would not be in the investors' interest to disclose, for example, that a confidential study revealed the

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33. For the classic statement of how the pursuit of trading profits can lead to excessive search, see Hirshleifer, *The Private and Social Value of Information and the Reward to Inventive Activity*, 61 AM. ECON. REV. 561 (1971); cf. Barzel, *Some Fallacies in the Interpretation of Information Costs*, 20 J.L. & ECON. 291 (1977) (demonstrating how markets find solutions to incentives to engage in excessive search).

34. Grossman, *The Informational Role of Warranties and Private Disclosure About Product Quality*, 24 J.L. & ECON. 461 (1981); Grossman & Hart, *Disclosure Laws and Takeover Bids*, 35 J. FIN. 323 (1980).

35. Fischel, *The Corporate Governance Movement*, 35 VAND. L. REV. 1259, 1278 (1982).

presence of valuable mineral ore deposits on land the firm intends to purchase.

Since the firm's shareholders value the ability to control information that flows to the stock market, they may also value insider trading because it gives the firm an additional method of communicating and controlling information. If insiders trade, the share price will move closer to what it would have been had the information been disclosed. How close will depend on the amount of "noise" surrounding the trade. The greater the ability of market participants to identify insider trading, the more information such trading will convey.<sup>36</sup> At the extreme, trading by insiders is as fully revealing as complete disclosure. But since insiders will limit the size of their positions because of risk aversion and will camouflage their trading to some degree, they convey less information by trading than that conveyed by (credible) full disclosure.

Several reasons explain why communicating information through insider trading may be of value to the firm. Through insider trading, a firm can convey information it could not feasibly announce publicly because an announcement would destroy the value of the information, would be too expensive, not believable, or—owing to the uncertainty of the information—would subject the firm to massive damage liability if it turned out *ex post* to be incorrect. Conversely, firms also could use insider trading to limit the amount of information to be reflected in price.<sup>37</sup> Controlling the number of traders who have access to information may be easier than controlling how much information gets announced over time. In other words, announcement of information need not be continuous, while trading on inside information can be.<sup>38</sup> Thus, insider trading gives firms a tool either to increase or to decrease the amount of information that is contained in share prices.<sup>39</sup>

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36. See Plott & Sunder, *Efficiency of Experimental Security Markets with Insider Information: An Application of Rational-Expectations Models*, 90 J. POL. ECON. 663 (1982) (demonstration using simulation techniques that markets adjust very rapidly to inside information).

37. Complete disclosure might not be optimal if shareholders cannot diversify or insure the risks to which the disclosure exposes them. See Hirshleifer, *supra* note 33, at 567-69.

38. Disclosure of information could be made continuous by repeated announcements of probabilities of future states. Antifraud rules, however, constrain this technique. A firm, for example, could not announce that the probability of a new discovery is .52 if the discovery has already been made.

39. An alternative to insider trading to communicate information is for the firm itself to convey information by the purchase and sale of shares. The difficulty with this alternative is that there is little incentive for an employee to reveal information to the firm's trader.

### B. *Efficiency Effects*

Because managers are agents whose actions cannot be monitored perfectly by their principals, managers have the ability and the incentive to take actions that are in their best interests but not necessarily in the best interests of the firm. Managers have incentives to divert more of the income stream generated by the firm's assets to themselves than they initially agreed upon. Alternatively, managers simply may not work hard. As a result of imperfect monitoring in the principal-agent relationship, managers also may be able to choose investment projects that are not optimal for the firm but that further the managers' interests. For example, a manager who is risk averse will be reluctant to take on high-payout, high-variance projects for fear that bankruptcy will occur or that poor performance will be attributed to him rather than to bad luck.

Markets limit the divergence of interest between managers and shareholders. Competition in product and capital markets limits the ability of managers to pursue actions that do not maximize the value of the firm. The market in corporate control also gives managers an incentive to maximize the value of the firm and simultaneously provides a mechanism for the removal of managers who perform poorly. Finally, given the market for managerial services, value-reducing behavior is constrained by managers' desires to increase the future value of their services to both current and prospective employers.

Because these markets do not work perfectly, however, they reduce rather than eliminate the divergence of interests between managers and shareholders. Since the costs of identifying and removing ineffective managers are positive, managers are able to engage in some shirking without fear of removal. But rational shareholders realize this and decrease the price they are willing to pay for shares accordingly. This in turn limits managers' compensation because the less shareholders are willing to pay for shares, the less managers will be able to charge for their services. Thus, both managers and shareholders have incentives to reach agreements *ex ante* that limit divergent behavior by managers: Such agreements increase the price shareholders are willing to pay for shares and hence the compensation managers are able to receive.<sup>40</sup>

A common scheme to make managers' interests conform more closely to those of the firm is to give them a stake in the firm. Indeed,

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40. See Jensen & Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976).

recent research suggests that managers frequently own a higher percentage of the firm's shares than has been commonly assumed.<sup>41</sup> The risk aversion of managers, however, acts as a constraint on their willingness to invest a large percentage of their wealth, which includes their human capital, in one firm.<sup>42</sup> So long as a manager does not own the entire firm, some divergence of interest will remain.

As another possible solution to the agency cost problem, firms may write contracts that induce managers to take efficient actions.<sup>43</sup> Paying a worker [on] a piece rate rather than a fixed salary creates the correct incentives if the employer can more easily observe output than effort. But the principal may have difficulty in many cases in observing output directly—especially the output of managers. Even if output can be observed, it will typically depend on factors other than just one manager's performance, such as the efforts of other managers or random events such as developments in the relevant industry or in the economy as a whole.

Contracts that provide for periodic renegotiations ex post based on (imperfectly) observed effort and output are alternatives to contracts that ex ante tie compensation to output.<sup>44</sup> Such renegotiations are constrained by the difficulty of monitoring the effort and measuring the output of individual managers, and the bargaining process itself is costly. To reduce these costs, firms seek to minimize the number of renegotiations. But reduction in the number of renegotiations itself creates a cost. If renegotiations occur too infrequently, they are less likely to exert the proper incentives at any given time. The firm may solve this problem by having more frequent renegotiations, but in doing so it must incur the costs associated with renegotiation.<sup>45</sup>

Insider trading may present a solution to this cost-of-renegotiation dilemma. The unique advantage of insider trading is that it allows a manager to alter his compensation package in light of new knowledge, thereby avoiding continual renegotiation. The manager,

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41. Demsetz, *The Structure of Ownership and the Theory of the Firm*, 26 J.L. & ECON. 375 (1983).

42. For ways in which shareholders can convince managers to hold a larger stake in the firm despite their risk aversion, see Beck & Zorn, *Managerial Incentives in a Stock Market Economy*, 37 J. FIN. 1151 (1982).

43. Fiduciary duties and voting rules in corporate law serve to minimize the costs of contracting and thus reduce agency costs. See generally Easterbrook & Fischel, *Corporate Control Transactions*, *supra* note 20; Easterbrook & Fischel, *supra* note 15.

44. See Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288 (1980).

45. For an extended discussion of the costs and benefits of salary renegotiations, see Smith & Watts, *supra* note 27, at 145-47.

in effect, "renegotiates" each time he trades. This in turn increases the manager's incentive to acquire and develop valuable information in the first place (as well as to invest in firm-specific human capital).<sup>46</sup> If a manager observes a possible valuable investment for the firm—such as a potential value-increasing merger or a possible new technology—he will be more inclined to pursue this opportunity if he is rewarded upon success.<sup>47</sup> Insider trading is one such reward. The alternative is to tell others of the opportunity, explain that it can be realized with extra effort, and hope to be compensated by some form of ex post settlement. The insider trading alternative reduces the uncertainty and cost of renegotiation and thus increases the incentives of managers to produce valuable information.<sup>48</sup> Moreover, because managers themselves determine the frequency of "renegotiations," they can tailor their compensation scheme to their particular attitudes towards risk.

A related advantage of insider trading is that it provides firms with valuable information concerning prospective managers. It is difficult for firms to identify those prospective managers who will work hard and not be overly risk averse in their choice of investment projects. Basing compensation in part on insider trading is one method for sorting superior from inferior managers. Because insider trading rewards those managers who create valuable information and are willing to take risks, managers who most prefer such compensation schemes may be those who are the least risk averse and the

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46. Anthony Kronman has raised the question of whether regulatory attempts to curb insider trading can be justified by "the idea that inside information is more likely to be casually discovered rather than deliberately produced." Kronman, *Mistake, Disclosure, Information, and the Law of Contracts*, 7 J. LEGAL STUD. 1, 34 (1978). The difficulty with phrasing the question in this manner is the assumption that the valuable information already exists. Most valuable information must be deliberately produced before it can be casually acquired. As we have explained, a prohibition against insider trading that is enforced effectively would discourage the production of valuable information.

47. For a discussion of the importance of property rights in information to create incentives to produce information in the tender offer context, see Fischel, *Efficient Capital Market Theory, the Market for Corporate Control, and the Regulation of Cash Tender Offers*, 57 TEX. L. REV. 1 (1978); see also Kronman, *supra* note 46, at 9-18 (similar analysis with respect to law of contracts). For a more general discussion of the problem, see Easterbrook, *Insider Trading*, *supra* note 1.

48. The incentive effect associated with insider trading is likely to be more valuable in unregulated firms where the possibilities for realizing the benefits from value-increasing activities are greater. We predict, therefore, that insider trading is less common in regulated industries. Cf. Smith & Watts, *supra* note 27 (finding that incentive plans are more common in unregulated firms).



most capable.<sup>49</sup> Thus, with insider trading, self-selection minimizes the costs of screening potential managers, the monitoring costs created by risk-averse managers, and the opportunity costs resulting from suboptimal investment decisions.

Critics of insider trading correctly point out that compensation schemes that allow insider trading could backfire, particularly if short selling is permitted, since managers would have incentives to reduce the value of the firm. We think that the force of this argument has been exaggerated, a view which we develop in the next section. For present purposes, we wish to emphasize that allowing managers to profit by a decrease in the value of the firm may increase their incentive to *increase* the value of the firm. Insiders are worried about the value of their human capital. If a project succeeds, the insider's value as a manager is increased. But if the project fails, even if the investment was optimal *ex ante*, the manager will suffer a loss in the value of his human capital because he may be blamed for the failure (the usual monitoring problem).<sup>50</sup> To avoid this loss, managers will tend to accept investment projects that reduce volatility of cash flows even if they do not maximize the value of the firm. By permitting managers to sell short and thereby profit from investment projects that are optimal *ex ante*, even if they do not turn out well *ex post*, insider trading may induce managers to take on projects with a high expected return even if they are riskier.<sup>51</sup> The ability to profit by selling, therefore, as well as the ability to profit by buying, may reduce divergence of interests between managers and shareholders by causing managers to behave in a less risk-averse manner.

### III. THE ARGUMENTS AGAINST INSIDER TRADING

Critics have marshalled a wide array of arguments against insider trading. We do not attempt to analyze all of these arguments in detail, but rather focus on the major claims made by critics of insider trading. Nor is our purpose to demonstrate that none of the argu-

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49. Recall that diversified investors do not want overly risk-averse managers running the firm.

50. The monitoring problem arises because the principal cannot perfectly observe the actions of the agent. The principal can observe the outcome, which depends only partially on the agent's actions. The principal has no choice but to infer that the agent was operating properly when outcomes are good and improperly when outcomes are bad.

51. See Demsetz, *Perfect Competition, Regulation, and the Stock Market*, in *ECONOMIC POLICY AND THE REGULATION OF CORPORATE SECURITIES* 1, 15 (H. Manne ed. 1969) ("If we wish decision makers who are risk averse to behave as if they are risk neutral, we may need to increase the reward they derive from successful decisions and reduce the penalty they suffer from unsuccessful decisions.").

ments against insider trading has any merit. But to show that insider trading would not be optimal in a world of perfect information is not a compelling argument for prohibiting insider trading in a world of costly monitoring and imperfect information. Whether the costs of insider trading outweigh the benefits is an empirical question. The apparent absence of widespread prohibitions of insider trading in employment contracts and corporate charters and the existence of common law rules permitting insider trading create a strong presumption that the practice may be beneficial in some circumstances. We argue in this section that the opponents of insider trading have not overcome this strong presumption.

A. *The Problems of Moral Hazard and Unbundling*

Many commentators have argued that insider trading is harmful because it creates a moral hazard by allowing insiders to profit on bad news.<sup>52</sup> At the extreme, they claim that allowing insiders to profit on bad information makes managers indifferent between working to make the firm prosperous and working to make it bankrupt. Another variant of this argument is that insider trading creates incentives for insiders to disseminate false information about the firm so that they can profit by buying and selling mispriced securities.<sup>53</sup> The moral hazard problem is related to the more general but less frequently recognized problem that insider trading allows insiders to unbundle or undo compensation agreements negotiated with the firm. The insider can undo the incentive effects of a stock ownership plan, for example, by selling an equivalent amount of stock. Banning insider trading would prevent insiders from undoing compensation agreements in this manner.

Prohibiting insider trading may be an overly blunt weapon to combat the problems of moral hazard and unbundling. These problems are most acute if short selling is permitted and therefore would be substantially eliminated if short selling, but not other forms of insider trading, were forbidden. Even limited to short selling, however, the argument is far from persuasive. First, short selling may have benefits, as discussed above, if it induces managers to invest in a way that maximizes the value of the firm.<sup>54</sup> Second, the problems themselves may be less severe than commonly assumed. Managers often work in teams and thus must first persuade one an-

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52. See note 3 *supra* and accompanying text.

53. See Ross, *Disclosure Regulation*, *supra* note 1, at 185.

54. See notes 50-51 *supra* and accompanying text.

other that the firm should undertake a particular strategy. If a manager uncovers a good opportunity, his efforts will be magnified by the efforts of other managers and employees who themselves will profit by increasing the value of the firm because their own compensation is thereby increased. The same is not true for poor opportunities. Because each manager will be concerned with his own compensation, which will be tied to the performance of the firm, as well as his long run interest in his human capital, he will be unlikely to go along with a strategy that decreases the value of the firm. Thus, the ability of any one manager to pursue bad opportunities will be constrained because other managers and employees will attempt to maximize the firm's value. Collusion to decrease the value of the firm among managers in pursuit of trading profits is unlikely to succeed because, as in all cartels, each rational member will cheat insofar as the gains to a lone cheater from exposing others will exceed his gains from collusion.<sup>55</sup>

Moreover, the moral hazard and unbundling problems are potentially present in a wide variety of situations where existing insider trading rules do not apply, and casual empiricism suggests that the resulting costs are insignificant. For example, with respect to insider trading, the actions of a key executive of a firm do not differ in principle from those of a key supplier to the firm. If short selling creates a serious moral hazard for a key executive, it must also do so for a key supplier. An executive of the supplier could sell the firm's shares short with little fear of penalty from insider trading laws<sup>56</sup> and then, as long as damages for breach (including those to the supplier's reputation) were less than trading gains, profit from failing to deliver urgently needed materials to the firm.<sup>57</sup> But this possibility is not perceived as a problem, presumably because of the incentives of the supply executive and the supplier itself to develop a reputation as reliable and trustworthy for future commercial dealings. Precisely

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55. See G. STIGLER, *A Theory of Oligopoly*, in *THE ORGANIZATION OF INDUSTRY* 39 (1968).

56. The supplier probably owes no fiduciary duty to the shareholders of another firm and has received no inside information from the firm. See *Chiarella v. United States*, 445 U.S. 222, 231-35 (1980).

57. We are using the concept of breach in a descriptive rather than a technical legal sense. If the breach is too blatant, the supplier might be liable for the full extent of the decrease in the value of the firm, thereby eliminating the gains from trading profits. Of course, this is also true for the insider who drives the firm into bankruptcy in order to profit from short selling. (The business judgment rule would not apply in this situation because of the obvious conflict of interest.) The point is that in both cases, a wide range of actions can be taken to decrease the value of the firm and yet avoid an action for damages.

the same is true for key executives of the firm, who have analogous reputational interests that provide incentives for them to maximize the value of their services.

Similarly, instead of selling their own firm short, key executives, by taking a long position in the securities of competitors whose income streams are highly correlated with the income stream of their own firm, can profit by taking actions unfavorable to their own firm.<sup>58</sup> No evidence suggests, however, that the availability of this practice seriously distorts the incentives of insiders to maximize the value of their firms.

In short, the perverse incentive effects that some attribute to insider trading would, for the same reasons, lurk in many practices that are currently unregulated. Given the lack of problems that short selling seems to have engendered (we are not aware of any empirical documentation in the economic literature pointing out the seriousness of these problems), it seems likely that the critics of insider trading have exaggerated the magnitude of the perverse incentives associated with short selling.

### B. *Risky Investments*

A related argument made by Richard Leftwich and Robert Verrecchia<sup>59</sup> and Frank Easterbrook<sup>60</sup> is that insiders who trade have a perverse incentive to choose risky (high-variance) projects. Risky projects have a wider range of possible future outcomes, the argument runs, and thus increase the ability of insiders to obtain trading profits on the basis of their superior information. One response is that the incentive to choose riskier projects is not necessarily bad. Stock options increase in value as the volatility of the firm's cash flows increases<sup>61</sup> but no one ever has suggested persuasively that they are inefficient for this reason. On the contrary, the incentive to increase volatility may be one explanation for the existence of stock options. Because managers are risk averse, they, like bondholders, will tend to choose less risky projects even if the value of the firm is

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58. Firms could limit the ability of managers to engage in this practice by acquiring other firms whose income streams are not highly correlated. Nobody has argued, however, that avoidance of insider trading is an explanation for conglomerate mergers.

59. See R. Leftwich & R. Verrecchia, *supra* note 1.

60. See Easterbrook, *Insider Trading*, *supra* note 1, at 332.

61. See Black & Scholes, *The Pricing of Options and Corporate Liabilities*, 81 J. POL. ECON. 637, 644 (1973).

not maximized.<sup>62</sup> An incentive device such as insider trading that, like a stock option, counters this tendency to choose less risky projects may promote shareholders' welfare.

If the claim is that insider trading causes managers to go to the opposite extreme and choose risky projects even at the expense of reducing the value of the firm, the argument and the responses are identical to the moral hazard argument.<sup>63</sup> The reality that managers must work in teams and the various incentives that managers have to maximize the value of their own services suggest that the temptation for managers to engage in value-decreasing activities for the purpose of trading profits may be quite limited. To the extent that some discretion remains, restrictions on insider trading may have little if any effect because of the managers' ability to achieve identical results by speculating in the securities of other firms whose income streams are highly correlated with that of their own firm.

### C. *Insider Trading As an Inefficient Compensation Scheme*

Kenneth Scott and Frank Easterbrook have argued that to compensate managers by allowing them to trade on inside information is akin to compensating them with lottery tickets.<sup>64</sup> Because managers are risk averse, the argument runs, they gain less from receiving lottery tickets than the (risk-neutral) shareholders lose.<sup>65</sup> Thus, both managers and shareholders would be better off if such an inefficient compensation scheme were eliminated.

The first difficulty with this reasoning is that lottery tickets given every day are much more likely to be valued at their expected value than tickets given once a lifetime.<sup>66</sup> Thus, insider trading may be a less risky form of compensation scheme than commonly is assumed.

Second, and more importantly, the argument ignores the value of providing managers with contingent claims on the firm's income stream as a solution to the principal-agent problem. While share-

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62. See Smith & Watts, *supra* note 27; see also Shavell, *Risk Sharing and Incentives in the Principal and Agent Relationship*, 10 *BELL J. ECON.* 55, 66 (1979).

63. See text accompanying notes 52-58 *supra*.

64. See note 7 *supra* and accompanying text.

65. Shareholders need not be risk neutral for this argument to apply. Many risk-averse shareholders, each holding only a small fraction of the firm in their optimal portfolio, will suffice.

66. This suggests that the expected value of trading profits will be less likely to be part of a compensation scheme where the relationship is short lived, the opportunities to trade are infrequent, and the stakes are large and highly uncertain (e.g., hiring an outside legal expert to investigate the legality of a proposed merger). See text accompanying note 95 *infra*.

holders could assume most risk by providing managers with career-long fixed claims on the firm's income stream, such a compensation scheme would not be optimal. As we have emphasized, a manager with a fixed claim on the firm's income stream would, like a bondholder, tend to prefer projects that reduce variability of cash flows, even if the value of the firm is decreased. Low-risk projects ensure that the firm's cash flows will be sufficient to cover the managers' fixed claims and therefore give these claims greater value. But while the managers' fixed claims are more secure, the value of the residual claims of the shareholders may decrease.<sup>67</sup>

Contingent payments, whether in the form of bonuses, stock options, salary renegotiation, or insider trading, can tie managers' fortunes more closely to those of the firm. When used in lieu of salary, the expected value of these contingent payments is likely to exceed the expected value of salary because managers must be compensated for accepting this increased risk. But shareholders are not troubled by this possibility because they realize that contingent payments will lead to a larger pie of which both shareholders and managers will receive a larger slice.<sup>68</sup> Therefore, managers' risk aversion does not cause insider trading, any more than any other form of contingent payment, to be an inefficient compensation scheme.

Stephen Ross has proposed another variant of the inefficient-compensation-scheme hypothesis. Ross argues that the market for managerial services is not competitive, and as a result, managers are able to obtain contracts that allow insider trading. Insider trading enables managers to obtain higher compensation than they would receive if labor markets were competitive.<sup>69</sup> But there is no evidence to support the premise that labor markets are not competitive, and Ross suggests none. Moreover, Ross suggests no reason why, if labor markets really are not competitive, managers would use their monopoly power to trade on inside information rather than simply demanding a higher salary.

A final version of the argument that insider trading is an ineffi-

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67. Managers with fixed claims do not share in the "upside" and so are indifferent to returns above their claims. Managers also have more wealth tied up in one firm and are less able to diversify. Shareholders, on the other hand, would prefer that project decisions be based on present value analysis, which assesses the combination of both risk and return.

68. This principle has limits. The increased expected value of contingent payments is worth paying only if there is a corresponding incentive effect. Thus, top managers are more likely to be paid a higher percentage of their total compensation in contingent claims than are janitors. See note 48 *supra*; text accompanying note 95 *infra*.

69. Ross, *Disclosure Regulation*, *supra* note 1, at 184, 193.

cient compensation device is that it works very imperfectly. Insiders, the argument runs, frequently will be compensated because of their fortuitous access to information rather than as a result of increased effort; even noninsiders such as janitors or secretaries will derive benefits from information.<sup>70</sup> At the extreme, the notion is that access to valuable information is substantially random. Again, however, there is no evidence in support of this position. Indeed, empirical evidence suggests that trading profits are positively correlated with position in the firms—the more important the position, the greater the trading profits.<sup>71</sup> This is not to suggest that access to valuable information will never be fortuitous. But to conclude that insider trading is an inefficient compensation scheme for this reason is a form of the Nirvana fallacy whereby existing arrangements are viewed as inferior to those that would prevail in a perfect world with zero information and transaction costs. No compensation scheme works perfectly. Managers may profit from a stock option plan, for example, because of an upturn in the market as a whole as opposed to their own productivity. The stock might have reached the same price without the stock option plan. But this possibility does not prove that stock option plans are inefficient. The relevant inquiry is not whether insider trading, stock options, or other forms of compensation work perfectly, but whether, in a world of imperfect compensation and costly monitoring, the same benefits can be obtained at lower cost from other imperfect types of compensation. Unless this can be shown, it is impossible to conclude that insider trading is an inefficient compensation scheme.

#### D. *Business Property*

Several commentators have stressed that insider trading should not be permitted in situations involving business property.<sup>72</sup> But this is simply another way of stating that insiders should not be allowed to appropriate a property right in information where the right has been allocated to the firm. It does not address the key question of why the firm and not the managers always should be allocated the property right in information. Obviously, if the firm chooses to allocate the information right to the managers and allows insider trad-

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70. Levmore, *supra* note 1, at 149; Scott, *supra* note 1, at 809.

71. See H. Seyhun, Analysis of Market Response to Insider Trading Information (May 3, 1983) (unpublished manuscript) (on file with *Stanford Law Review*).

72. Easterbrook, *Insider Trading*, *supra* note 1, at 334; Scott, *supra* note 1, at 814-15, 817-18.

ing, then insider trading cannot be construed as a taking of business property.

#### E. *Timing of Disclosure*

Yet another argument made against insider trading is that it causes the disclosure of information to be delayed.<sup>73</sup> Like the other criticisms of insider trading, this one is a logical possibility, but has little empirical basis.<sup>74</sup> Our analysis demonstrates, moreover, that delaying disclosure of information may be beneficial in some situations. For example, some valuable information should be kept from competitors if it is to retain its value. Furthermore, the argument assumes that all information can be disclosed. But information such as revisions of probabilities of future states cannot necessarily be conveyed directly. In cases where disclosure otherwise would be either undesirable or impossible, insider trading gives firms an additional method for communicating information. Finally, insider trading in some cases may accelerate the speed of disclosure because the ability to profit is dependent on information reaching the market. Thus insiders, if allowed to trade, may have strong incentives to communicate information to the market.

#### F. *The Liquidity of the Stock Market*

Insider trading allows individuals to profit by trading on superior information. If transactions occur between uninformed and informed traders who are otherwise identical and if the uninformed know this, then the uninformed should realize that they could be better off not trading. In order to induce trade, something must prevent the uninformed from holding the "market" and not trading. Otherwise, markets for stock would become less liquid, and consequently, the people who have to trade for exogenous reasons (e.g., to pay for a child's tuition or to reallocate portfolios because of new inheritances) perforce would provide the profits for insider trading. Insider trading could be detrimental to the extent it reduces liquidity.

This problem raises the more general question of why the uninformed ever trade in individual stocks, a question to which theory provides no convincing answer.<sup>75</sup> Suffice it to say that no obvious

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73. See note 6 *supra* and accompanying text.

74. See Dooley, *supra* note 1, at 34 (finding, after examining cases, that insider trading did not delay the public disclosure of information).

75. For a discussion of this problem, see Stiglitz, *Information and Capital Markets*, in Fi-



logic indicates that insider trading has any substantial effect on liquidity. If insiders could not trade, the gains to noninsiders from discovering nonpublic information would be higher and investors would have an incentive to expend resources to uncover such information. In fact, the only effect a ban on insider trading might have is that those with better access to information, such as brokers, would reap some of the gains from inside information. While this may be inefficient because brokers can become informed only at a higher cost, the informed-uninformed trader problem remains. Smart brokers, in other words, cause the same problem as smart insiders. Uninformed traders who know they are uninformed should not trade in either situation. That trade occurs suggests that traders either do not believe they are uninformed or realize that enough informed trading occurs for the prevailing prices to reflect most material information.<sup>76</sup>

### G. *Fairness Arguments*

We have left for last the most common argument against insider trading—that it is unfair or immoral. The prevalence of this intui-

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NANCIAL ECONOMICS: ESSAYS IN HONOR OF PAUL COOTNER 118 (W. Sharpe & C. Cootner eds. 1982).

76. Even if insider trading does reduce liquidity in the market for stock, firms, which would presumably bear the resulting costs, would try to prohibit insider trading. Such prohibitions would not be forthcoming only if the loss of liquidity imposed externalities—that is, if all firms whose stocks are traded on a particular exchange shared in the costs of any one firm allowing insider trading. The notion is that the exchange suffers when liquidity of any one stock is reduced. (The economic theory of market exchanges is still in its infancy. *See* Telser, *Why There Are Organized Futures Markets*, 24 J.L. & ECON. 1 (1982) (explaining existence of organized futures markets).) If true, this argument could provide grounds for prohibitions that firms could not opt out of. The prohibitions would come from stock exchanges themselves, as they compete with each other for optimal rules. Federal regulations would not be needed, unless the subpoena power of the state constitutes an enforcement advantage. Interestingly, some foreign stock exchanges (e.g., in the U.K.) have suggested guidelines governing insider trading. P. RIDER & H. FRENCH, *supra* note 16, at 166–70. Still, the notion that exchanges are harmed by insider trading is hard to square with the following facts: (1) the stock market was successful pre-1933 (before insider trading laws); (2) the stock market was successful pre-1960's (before judicial extension of insider trading laws); (3) the stock market is currently successful despite the existence of legal and perhaps illegal insider trading. A useful empirical study would be an analysis of the price of a seat on the New York Stock Exchange before and after judicial extension of Rule 10b-5 in *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968) (en banc), *cert. denied*, 404 U.S. 1005 (1971).

Another externality related argument against insider trading is that the reduced liquidity of one stock could affect information about another stock. For example, if firms A and B compete, the price movements of firm A could reveal information about firm B (e.g., common industry demand). If stock of firm A is traded less frequently, information about firm B could be diminished. We are grateful to Ivan P'ng for this point. On the other hand, if insider trading causes the stock of firm A to be more informative, *see* text accompanying notes 33–39 *supra*, information about firm B could be increased.

tion is so powerful that many commentators have argued that insider trading should be prohibited even if it is efficient.<sup>77</sup> What is commonly left unsaid is how and why insider trading is unfair.<sup>78</sup>

Kenneth Scott has pointed out that if the existence of insider trading is known, as it surely is, outsiders will not be disadvantaged because the price they pay will reflect the risk of insider trading.<sup>79</sup> This is a useful insight and in some sense is a complete response to the claim that investors are exploited by insider trading. But the argument does not address the desirability of insider trading. If traders knew that a firm burned half of its assets, the price would fall and subsequent investors in the firm would have the same expected returns as any other asset of comparable risk. But the fact that investors would not be fooled does not mean that burning assets is a beneficial practice. On the contrary, firms that followed this strategy to a substantial degree, like firms that adopted inefficient compensation schemes, could not survive over time.

A more powerful response to the argument that insiders profit at the expense of outsiders is that if insider trading is a desirable compensation scheme, it benefits insiders and outsiders alike. Nobody would argue seriously that salaries, options, bonuses, and other compensation devices allow insiders to profit at the expense of outsiders because these sums otherwise would have gone to shareholders. Compensating managers in this fashion increases the size of the pie, and thus outsiders as well as insiders profit from the incentives managers are given to increase the value of the firm. Insider trading does not come "at the expense of" outsiders for precisely the same reason.<sup>80</sup>

Contrary to popular sentiment with respect to insider trading,

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77. See, e.g., Schotland, *supra* note 2, at 1439 ("Even if we found that unfettered insider trading would bring an economic gain, we might still forgo that gain in order to secure a stock market and intracorporate relationships that satisfy such noneconomic goals as fairness, just rewards and integrity.")

78. For an excellent discussion and refutation of the various forms of the fairness arguments in the context of insider trading, see Easterbrook, *Insider Trading*, *supra* note 1, at 323-30.

79. Scott, *supra* note 1, at 807-09.

80. Numerous commentators have argued that insider trading raises firms' cost of capital because insiders' gains are diverted from, and therefore come "at the expense of," outsiders. See Mendelson, *supra* note 1, at 477-78; note 8 *supra* and accompanying text. One fallacy in this argument is that it assumes the size of the pie is fixed. Under this logic, all forms of managerial compensation would raise firms' cost of capital because shareholders receive less than they otherwise would. Moreover, even if the size of the pie is fixed, the argument ignores that in a competitive labor market, the salary of a manager who cannot trade on inside information will be higher than that of a manager who can trade. The stockholder class as a

therefore, there is no tension between considerations of fairness and of efficiency. To say that insider trading is a desirable method of compensating corporate managers is to say that shareholders would voluntarily enter into contractual arrangements with insiders giving them property rights in valuable information. If insider trading is efficient, no independent notions of fairness suggest that it should be prohibited.

#### IV. LEGAL RULES RESTRICTING INSIDER TRADING

In this section, we analyze the common law and various state and federal rules governing insider trading. At the outset, we should note the fundamental difference between state and federal rules governing internal corporate relationships. States' ability to enact rules that reduce investors' welfare is limited by competition between states. If one state adopts inefficient rules, it is a simple matter for a firm to avoid them by reincorporating in another state. Therefore, state statutory and common law rules that survive over time, like private contractual arrangements, are presumptively welfare increasing. Not surprisingly, enabling statutes such as Delaware's, which allow private parties to structure their affairs with relative freedom, have demonstrated the greatest survival qualities.<sup>81</sup>

Analysis of federal rules yields exactly the opposite conclusion. Federal rules—whether pertaining to the amount of information produced, the types of issues on which shareholders are entitled to vote, or whether firms can structure compensation packages that include a property right in information—displace private arrangements and the competition between states. Although firms can avoid these rules by not incorporating or by “going private,” they obviously would find these alternatives more costly than simply changing the state of incorporation. Federal rules governing insider trading or any other aspect of intracorporate activity, therefore, are not entitled to the same presumption of efficiency as are long-standing state rules.<sup>82</sup>

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whole winds up paying the managers' compensation whether or not insider trading is ultimately part of the manager's compensation package.

81. See R. WINTER, *supra* note 15, at 7–11; Fischel, *supra* note 15, at 921–23. For an empirical study demonstrating that reincorporation in Delaware increases shareholders' welfare, see Dodd & Leftwich, *The Market for Corporate Charters: “Unhealthy Competition” versus Federal Regulation*, 53 J. BUS. 259 (1980).

82. For a similar analysis with respect to legal rules governing voting, see Easterbrook & Fischel, *supra* note 15, at 418–19.

A. *Common Law Rules*

The general common law rule is that insider trading in publicly traded corporations is permitted.<sup>83</sup> Failure by an insider to disclose information before trading is not actionable. Neither the corporation nor an investor trading on the opposite side of a transaction to the insider has any legal remedies against the insider. This general common law rule has some exceptions. Some jurisdictions allowed suits against insiders for trading if the plaintiff could prove "special facts"—that his trade was induced by express or implied misrepresentations concerning the value of the securities or the identity of the purchaser.<sup>84</sup> Corporations also have been allowed to bring actions under the corporate opportunity doctrine against insiders who take advantage of their knowledge in ways that harm the firms' business.<sup>85</sup> For example, an employee who, upon learning of an impending land purchase or corporate repurchase plan, rushes out and purchases the land or shares in order to resell to the firm at a high price would be held to have usurped a corporate opportunity.

This general common law rule is consistent with our analysis. Because trading by insiders appears to be consistent with their contract with the firm, no action lies for the firm or for a shareholder on the firm's behalf.<sup>86</sup> If the insider (or someone acting on his behalf) makes misrepresentations about the value of the firm or his identity in convincing an uninformed outsider to sell, however, the informational effect of the trade that we have discussed above is lost. Indeed the trade, like other types of fraud, will move prices away from, rather than towards, the "correct" price, particularly if the trade is a face-to-face transaction as opposed to an impersonal one.<sup>87</sup> Moreover, the incentive effect created by allowing such trades would be to distort

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83. *See, e.g.*, *Goodwin v. Agassiz*, 283 Mass. 358, 186 N.E. 659 (1933); *see also* note 14 *supra*.

84. *See, e.g.*, *Strong v. Repide*, 213 U.S. 419 (1909). These cases typically did not involve publicly traded corporations and thus are not technically exceptions to the general common law rule.

85. *See, e.g.*, *Guth v. Loft, Inc.*, 23 Del. Ch. 255, 5 A.2d 503 (1939).

86. One well known case has held that there is such a cause of action. *See Diamond v. Oreamuno*, 24 N.Y.2d 494, 248 N.E.2d 910, 301 N.Y.S.2d 78 (1969). *Diamond*, however, is a clear departure from the common law rule and has not been followed by other courts. *See Freeman v. Decio*, 584 F.2d 186 (7th Cir. 1978); *Schein v. Chasen*, 519 F.2d 453 (2d Cir. 1975).

87. The price set by trading activity of different types of traders with different information protects the uninformed in impersonal exchanges in a way that is not present in face to face transactions. For an elaboration, see Fischel, *Use of Modern Finance Theory in Securities Fraud Cases Involving Actively Traded Securities*, 38 BUS. LAW. 1, 3-5 (1982).

information as opposed to producing new information. The "special facts" rule, therefore, is a recognition that trading by insiders need not be protected when such trading is not efficient.<sup>88</sup>

The rationale for applying the corporate opportunity doctrine to insider trading also seems clear. If actions based on insider information harm the firm, those actions will be prohibited. In the land case, the firm instead of buying land in a competitive market must now negotiate with the employee. Transaction costs have risen. Firms would prefer to ban such behavior and pay the employee through increased salary. Similarly, the purchase of a target's shares in advance of a takeover probably would be considered a usurpation of a corporate opportunity. The action bids up the price of the target firm's shares and thereby makes the corporate action more expensive. This reduces the value of the takeover to the firm.<sup>89</sup> Thus, fiduciary duties under common law ban nonconsensual use of inside information, whether through trading in shares or otherwise, where the precipitating event is so rare as not to justify an explicit contractual prohibition.

#### B. *Section 10(b) and Rule 10b-5*

Courts have recently interpreted section 10(b) of the Security Exchange Act of 1934 and Rule 10b-5, promulgated under the 1934 Act by the Securities and Exchange Commission, to require corporate insiders and tippees either to disclose material inside information or to refrain from trading.<sup>90</sup> Several aspects of this cause of action are analyzed below.

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88. Because the "special facts" exception typically has been applied to firms with few shareholders as opposed to publicly traded firms, it may also be premised, at least implicitly, on the difference between the principal-agent problems presented by the two situations.

89. This problem can arise in other contexts. In one case, *Brophy v. Cities Serv. Co.*, 31 Del. Ch. 241, 70 A.2d 5 (1949), an employee's purchase of his firm's shares in advance of an impending corporate repurchase program was deemed a breach of fiduciary duty. Just as in the takeover example, the insider's purchase of shares in this situation had the effect of making the firm's contemplated action (i.e. corporate repurchase of shares) more expensive. A complete analysis of the welfare consequences of the decision in this case would require a more satisfactory explanation of the purposes of a corporate repurchase than is currently available.

90. *See, e.g., SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968) (en banc), *cert. denied*, 404 U.S. 1005 (1971). This judicial development is, in all probability, contrary to congressional intent. There is no evidence that in enacting § 10(b) Congress intended to prohibit insider trading. In inferring a private damage remedy under Rule 10b-5 for insider trading, courts have invented both the substantive prohibition and a remedy for its violation. For a more complete articulation of this argument, see Dooley, *supra* note 1, at 55-69; Easterbrook, *Insider Trading, supra* note 1, at 317-20.

1. *The disclose-or-abstain-from-trading rule.*

Proponents of insider trading regulation may argue that section 10(b) and Rule 10b-5, as interpreted, do not actually prohibit insiders from trading; these provisions simply give the insider the option of either disclosing the nonpublic information or refraining from trading. Despite this formulation of the rule in the alternative, however, the rule, if enforced, actually operates as an almost complete prohibition against trading.

In many cases, the insider may not be able to disclose the information. For example, the information might be valuable to competitors. Indeed, it is in precisely such situations that insider trading may provide firms with a valuable additional method of communicating information to the market.<sup>91</sup> Forcing disclosure thus removes the firms' ability to use insider trading as a tool of communication when it is most needed. The result is usually neither trading nor disclosure.

In those situations where disclosure is both possible and not harmful to the firm, the act of disclosure in an efficient market will eliminate the gains to insiders from trading. The insider is then better off not trading. This outcome is undesirable if, as we have argued, the possibility of profits from trading gives managers an incentive to maximize the value of the firm to the benefit of themselves and shareholders alike. The disclose-or-abstain-from-trading rule weakens this incentive device.

The adverse effect of the rule on incentives to acquire valuable information is also evident in the context of investment analysts. These individuals perform a valuable economic function in monitoring corporate conduct and contributing to the efficient pricing of securities, which in turn leads to more effective markets in capital, managerial services, and corporate control.<sup>92</sup> Analysts' incentives to collect information about different firms lie in their ability to sell the acquired information to others or to profit directly by trading themselves. If they are unable to capitalize on the value of the information in one of these ways, analysts obviously will have no incentive to invest resources to gather information in the first place.<sup>93</sup> This is pre-

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91. See text accompanying notes 36-39 *supra*.

92. See generally Jensen & Meckling, *supra* note 40. It is impossible to make a welfare statement as to whether there are too many or too few investment analysts.

93. This point has been lost on the SEC, as illustrated by its prosecution of Raymond Dirks for his role as an investment analyst in uncovering one of the major corporate scandals in recent years. See Raymond L. Dirks, S.E.C. Release No. 17,480 (Jan. 26, 1981). The Supreme Court has recently held that Dirks did not act illegally because the insiders that gave him the information did not benefit, directly or indirectly, from tipping the information,

cisely the effect of the disclose-or-abstain-from-trading rule. As in the case of corporate insiders, therefore, applying the rule to analysts reduces the gains to beneficial economic activity and therefore decreases the frequency of its occurrence.

2. *The requirement of a trade on the basis of material inside information.*

The effect of Rule 10b-5 should not be exaggerated. The disclose-or-abstain-from-trading rule applies only if a defendant trades on the basis of "material" inside information such as knowledge of an oil discovery, impending merger, or major change in earnings. This ensures that section 10(b) and Rule 10b-5 will have a minimal impact on insiders' behavior.

Insiders, because of their superior access to information, do not need to trade in order to outperform the market. They simply can earn superior returns through careful selection of their initial purchases. Moreover, trades motivated by knowledge of "bombshell" events which are the substance of lawsuits are the aberration, not the rule. Far more common are trades that allow insiders to earn rates of return that are on average slightly in excess of the market as a whole on a risk-adjusted basis.<sup>94</sup> These trades, though based on "inside" information in an economic sense (i.e. knowledge of information not fully reflected in stock prices), are not subject to legal attack because the materiality requirement is not satisfied. Knowledge that one of the firm's top managers is dispirited because of family problems or because preliminary reports on a new technological

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but rather acted out of a desire to expose the fraud. *Dirks v. SEC*, 103 S. Ct. 3255, 3261-66 (1983). The existence of benefit is a question of fact to be determined by courts. *Id.* at 3265. Because many cases will exist where providing information to analysts will result in some type of benefit to the insider, the Court's test will not, in all probability, significantly decrease the application of Rule 10b-5 to investment analysts.

The Court's reasoning in *Dirks* is dubious. The Court stated that the "benefit" test was premised on the "inherent unfairness" when one takes advantage of "information intended to be available only for a corporate purpose and not for the personal benefit of anyone." *Id.* at 3261. The Court assumed that the property right in valuable information is always "intended" to be allocated to shareholders as opposed to managers. As we have argued, however, no basis exists for this assumption. *See* note 101 *infra*. Application of the "benefit" test will also be difficult. It would appear to allow an employee to give tips to individuals in anger or spite as long as he doesn't "profit." (Presumably he gains something—why else would he decide to release the information?) Tips to strangers are legal but tips to relatives are not. For a fuller analysis of *Dirks*, *see* Fischel, *Insider Trading and Investment Analysts: An Economic Analysis of Dirks v. Securities and Exchange Commission*, 3 SUP. CT. ECON. REV. — (forthcoming 1984).

94. *See* studies collected in note 12 *supra*.

process show that costs are running much higher than expected are examples of valuable information that is almost surely not material in a legal sense.<sup>95</sup> As long as insiders are allowed to own and trade shares, therefore, Rule 10b-5 is likely to have a minimal deterrent effect on most of the insiders' desired trading activities.

An argument could be made, however, that the materiality requirement effectively limits the operation of Rule 10b-5 to those cases of insider trading where the trading is inefficient. Certain classes of individuals—lawyers, accountants, printers, and government officials—typically receive valuable information only after it has been produced. Because the positive incentive effects created by allowing these individuals to trade are likely to be trivial or nonexistent, the firm may want to ban such trading. Similarly, in rare cases involving bombshell events where the rewards are large and highly uncertain, the value of the uncertain trading profits to risk-averse managers (and others) will be very low compared to the expected value of the event. Here again, insider trading might be an inefficient compensation scheme. In both classes of cases, firms might want to ban insider trading, but because the precipitating event is so rare, it simply may not be worth the (small) cost of including the prohibition in the corporate charter. If the materiality requirement acts as a filter distinguishing these two classes of cases from the more typical but less dramatic cases where insiders earn positive abnormal returns, it may be beneficial.

But the absence of observed contractual prohibitions before and after regulation and the failure of the common law to develop along these lines cast some doubt on this hypothesis. It may be, for example, that the incentive effects created by insider trading are most needed in connection with bombshell events such as identifying potential takeover targets or developing new technologies. Moreover, a firm might want to allow some individuals but not others to trade on the basis of material information. Thus, a firm might want to allow the manager who identifies a possible merger to trade on this information but simultaneously to deny the attorney who is hired to investigate the legality of the proposed merger the same ability. The materiality requirement, because it denies firms the ability to make this choice, is probably inefficient. Applying the materiality stan-

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95. For discussion of the distinction between the meaning of information in an economic sense and the legal definition of materiality, see Lorie, *Insider Trading: Rule 10b-5, Disclosure, and Corporate Privacy: A Comment*, 9 J. LEGAL STUD. 819, 820-21 (1980); see also Fischel, *supra* note 87, at 5-7; Heller, *supra* note 1, at 526-32.



dard only to those cases of clearly nonconsensual trading (i.e., purchasing shares of a potential target) would be more consistent with the common law.

### 3. *The requirement of fiduciary duty.*

The Supreme Court has drawn a sharp distinction between the ability of insiders and the ability of others, such as printers or government officials, to trade on the basis of nonpublic information.<sup>96</sup> Because insiders are employed by the firm and thus owe a fiduciary duty to investors, the Court has reasoned that insiders cannot trade on the basis of inside information. Outsiders owe no such duty, however, and thus can trade without violating section 10(b) or Rule 10b-5.<sup>97</sup>

The legal distinction between insiders and outsiders rests on a questionable basis. The difficulty with limiting the class of "insiders" to those within the firm is that long term contracts are often a substitute for horizontal or vertical integration.<sup>98</sup> Outside suppliers or outside counsel may have as much inside information and ability to affect the fortunes of the firm as employees.<sup>99</sup> Nor is invoking "fiduciary duties" helpful in resolving who should be allowed to trade on inside information. Fiduciary duties are standard-form contractual terms that govern agency relationships.<sup>100</sup> They allow the parties to avoid excessively lengthy and detailed agreements, thereby reducing the costs of contracting. But such duties should be imposed only as a constraint on conduct if there is very clear evidence that most parties would impose the identical constraint by contract if bargaining were costless. Otherwise, imposing fiduciary duties threatens to create regulatory constraints on private behavior in the name of standard-form contractual terms. For this reason, no basis exists for interpreting the

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96. See *Dirks v. SEC*, 103 S. Ct. 3255, 3261 (1983); *Chiarella v. United States*, 445 U.S. 222, 225-35 (1980).

97. Outsiders that are tippees, however, appear to be in the same position as insiders. See *Dirks*, 103 S. Ct. at 3261; *Chiarella*, 445 U.S. at 230 n.12. The Court has also stated that some outsiders such as accountants or lawyers who receive information solely for corporate purposes "may become fiduciaries of the shareholders" and thus insiders. *Dirks*, 103 S. Ct. at 3261 n.14.

98. Coase, *The Nature of the Firm*, 4 *ECONOMICA* 386, 391-92 (1937).

99. Under current legal rules, for example, a supplier to a firm could not be liable for selling the shares of the firm short, but it could be liable if the supplier were vertically integrated into the firm. See text accompanying notes 56-57 *supra*.

100. For a more detailed discussion of the function of fiduciary duties, see Easterbrook & Fischel, *Corporate Control Transactions*, *supra* note 20, at 700-03.

fiduciary duty of corporate managers to prohibit insider trading if some firms prefer to allow it.

The relevant question is whether trading on inside information is consensual, not whether the trader is an insider or outsider. If insider trading is an efficient method for compensating corporate managers, it should be permitted without interference from judicial or legislative notions of fiduciary duties.<sup>101</sup> Conversely, if a firm that intended to make a tender offer would not enter into a contract with a printer of the offering documents allowing him to purchase shares in advance of the offer, it should be irrelevant whether the printer is an outsider or an employee of the firm or whether the shares purchased are those of the target or another firm. Purchase of the shares by the printer might cause the price the firm must pay to rise, making the offer more expensive and producing no offsetting efficiency gains from superior printing. The same is true for suppliers, accountants, lawyers, and others in analogous positions. Whether these individuals are within the firm is a matter of firm organization that should have no effect on the propriety of trading.<sup>102</sup>

#### 4. *The proper plaintiff.*

Federal law creates both private and public enforcement devices against insider trading. Rule 10b-5, as interpreted, gives shareholders who bought and sold during the time insiders were trading standing to bring private damage suits.<sup>103</sup> The federal government also can bring injunctive and criminal actions.<sup>104</sup>

Both of these enforcement schemes are suspect. One of the themes we have emphasized is that the dispute concerning insider trading is really a dispute about how managerial contracts allocate the property right in valuable information. If this property right is allocated to the managers, neither shareholders nor the government

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101. The danger of invoking fiduciary duties is illustrated by the Court's statement in *Dirks v. SEC*, 103 S. Ct. 3255 (1983), that the securities laws were designed "to eliminate the idea that use of inside information for personal advantage was a normal emolument of corporate office." *Id.* at 3261 n.10. The problem with this logic is obvious once it is realized that insider trading, like salary, can be part of a manager's compensation scheme.

102. Casual empiricism suggests that many outside law and accounting firms often have rules preventing employees from trading in the shares of their clients. This provides a good instance of firms preventing insider trading when the positive incentive effects are likely to be small.

103. *See, e.g.*, *Elkind v. Liggett & Myers, Inc.*, 635 F.2d 156 (2d Cir. 1980).

104. *See, e.g.*, *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968) (en banc), *cert. denied*, 404 U.S. 1005 (1971) (injunctive action); *Chiarella v. United States*, 445 U.S. 222 (1980) (criminal action).

should have a cause of action. In cases of nonconsensual trading, such as trading by a printer in advance of a tender offer, the firm should have a cause of action for breach of contract.

As in any common law breach of contract action involving a corporation and an employee, the proper plaintiff should be the corporation or, when appropriate, a shareholder bringing a derivative suit on its behalf. The shareholder should have no more right to bring a direct action for insider trading than to challenge directly a salary or bonus decision. If a derivative action is brought, however, it should make no difference whether the complaining shareholder traded at the same time as the insider or, for that matter, traded at all.

The alternative to private enforcement is public enforcement. Because the probability of detection in situations involving nonconsensual trading is less than one and because the gains from trading are potentially great, the argument could be made that public, possibly criminal, enforcement with high penalties is preferable to private enforcement.<sup>105</sup> Insider trading laws under this interpretation would, in effect, be no different than other antitheft prohibitions involving trade secrets or other valuable information. Several reasons, however, suggest that public enforcement by the federal government may be of dubious value.

First, firms themselves may be able to control undesirable use of insider information as well as, and at a lower cost than, the government. Firms have considerable ability to control the flow of valuable information. Confidential information about the firm is not widely circulated. Low level employees whose trading might not produce significant incentive effects may never be privy to any inside information about the firm. Printers who do receive valuable information commonly receive it in code. The firm can monitor the trading activities of individuals likely to have access to inside information with reporting requirements. Moreover, firms can enter into arrangements with stock exchanges or other entities to monitor unusual trading activity in their securities. The ability of firms to control the flow of information as well as trading based on this information suggests, in short, that nonconsensual trading may not present a significant problem so that public enforcement would produce only small benefits.

Second, public enforcement may entail substantial costs. Apart from the obvious costs of regulators' salaries, offices, and other per-

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105. See Easterbrook, *Insider Trading*, *supra* note 1, at 334 (relying on Landes & Posner, *The Private Enforcement of Law*, 4 J. LEGAL STUD. 1 (1974)).

quisites, public enforcement with high penalties might deter a significant amount of beneficial, consensual insider trading, particularly because regulators, unlike firms, are not disciplined by markets. (This danger would be minimized, of course, if firms could trigger the insider trading prohibition in the same manner as they do other antitheft prohibitions.) Until greater evidence than is currently available shows that a problem actually exists, the case for public enforcement, particularly federal enforcement, has not been made.

The preferable course would be to allow competition among states, rather than federal fiat, to resolve the issue of the desirability of public enforcement of nonconsensual insider trading. If public enforcement, criminal or otherwise, is optimal, states have incentives to provide it. That states before and after federal regulation have not enacted public enforcement schemes directed against insider trading suggests that such schemes are not optimal.<sup>106</sup>

### C. Section 16

Section 16 of the Securities Exchange Act of 1934 requires directors, officers, and large stockholders (owning over 10% of the firm) to report trades in equity securities of their firm on a monthly basis, provides the firm with a cause of action to recover any profits made from the purchase and sale of securities in a 6-month period, and prohibits short selling. Section 16 differs from section 10(b) and Rule 10b-5 in several major respects: (1) Section 16 does not require trading on inside information for an action to lie—any short term profits made by buying and selling are recoverable;<sup>107</sup> (2) its scope is limited to the 6-month period; (3) it makes only specific insiders liable; and (4) it allows only the firm to recover.

#### 1. Reporting requirements.

Requiring insiders to report their trades allows investors to make more accurate inferences about insiders' compensation schedules. Moreover, requiring insiders to report their trades provides information to future managers about potential compensation that is avail-

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106. Federal regulation of insider trading does not eliminate the incentives of states to adopt their own regulatory schemes. Because federal regulation does not appear to have affected either the frequency or the profitability of trading, *see* note 11 *supra* and accompanying text, states (as well as firms) have strong incentives to deter the practice if it is detrimental to investors.

107. This prophylactic effect of § 16 has been weakened by judicial decisions that find liability under § 16 only where there has been a showing of a "possibility for speculative abuse." *See* *Kern County Land Co. v. Occidental Petroleum Corp.*, 411 U.S. 582, 601 (1973).

able. These benefits might be small, however, because of the difficulty of inferring information from trading profits when portfolio decisions may be governed by many factors. An additional benefit is that the information effect of the insiders' trades will be strengthened if trades are observable *ex post*. The cost of post-trade reporting requirements appears to be limited to the cost of implementing such requirements.

## 2. *The prohibition against short-swing trading.*

Section 16(b), which authorizes the corporation to recover short-swing profits, has the advantage of placing the cause of action with the corporation. The more basic question, however, is whether there should be a cause of action at all. If insider trading provides net benefits to the firm, why does it warrant different treatment when the buying and selling occurs within a 6-month period?

One possible response is that the prohibition of short-swing trading decreases the ability of insiders to manipulate stock prices (i.e., to move prices away from their equilibrium value).<sup>108</sup> Suppose that insiders knew that their purchases would cause the price of shares to rise. In this event, insiders could make capital gains by purchasing shares and then immediately reselling (or selling short) before the market became aware of the manipulation and settled back to its former level. Prohibiting the buying and selling of shares within a 6-month period reduces the ability of insiders to engage in this sort of practice. But the prohibition (assuming it is enforced) may also entail substantial costs. Both the incentive and information effects of insider trading are weakened if a substantial set of trades are prohibited. The prohibition of short-swing trading also has the effect of forcing managers to hold nondiversified portfolios for longer periods of time. This will necessitate raising their compensation from other sources. Moreover, the ability of insiders to manipulate stock prices should not be exaggerated. The reason the market price might rise if insiders purchase is that investors believe such purchases convey valuable information about the firm's prospects. Investors will believe this only if the message conveyed by the insiders' trades is borne out by an increase in the firm's earnings. Manipulation, in sum, is inherently a shortrun phenomenon. Insiders who mislead investors will have their future attempts to convey information discounted by the market. And managers will balance any shortrun gains against long-

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108. See H. MANNE, *INSIDER TRADING AND THE STOCK MARKET*, *supra* note 1, at 30.

run losses resulting from their inability to communicate information and, more generally, from a decrease in the value of their human capital.<sup>109</sup> In light of the low probability that manipulation is a serious problem and of the costs of a general prohibition of all buying and selling of securities within a 6-month period, the problem might better be addressed on a case-by-case basis, as are other types of fraud.

### 3. *Prohibition against short sales.*

The moral hazard and unbundling problems,<sup>110</sup> as well as the possible incentive of insiders to increase the volatility of earnings,<sup>111</sup> are most acute when insiders are permitted to engage in short selling. Section 16's prohibition against short selling can be viewed as an attempt to limit these perceived adverse consequences of insider trading.<sup>112</sup>

For the reasons discussed above,<sup>113</sup> however, we are skeptical of the magnitude of these effects. Moreover, banning short selling is not without costs. Short selling may be a valuable method of communicating information about the firm's prospects. In addition, the ability to short sell may induce managers to make superior investment decisions. In this event, shareholders might not contract for a ban on short selling.<sup>114</sup> This may explain why the common law made no distinction between short selling and other forms of insider trading.

The effect of section 16 on shareholders' welfare, therefore, is ambiguous. The reporting requirements, the prohibition against short-selling trading, and the ban on short sales all have a plausible basis, but also impose costs. The relative magnitudes of the costs and benefits are unknown. But the apparent absence of widespread private contractual arrangements or state law rules embodying restrictions

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109. For a similar argument that managers have little ability and incentive to use dividend policy to mislead investors, see Fischel, *The Law and Economics of Dividend Policy*, 67 VA. L. REV. 699 (1981).

110. See notes 52-58 *supra* and accompanying text.

111. See notes 59-63 *supra* and accompanying text.

112. Short selling is only a special case of selling by insiders who will frequently be substantial equity holders in the firm. While prohibiting short selling limits the gains on bad news, it by no means eliminates them. Managers can sell their shares on bad news and then replace them at lower cost after the market reacts.

113. See notes 52-63 *supra* and accompanying text.

114. This is not to suggest, however, that there may not be implicit contracts forbidding short sales in some circumstances. If a manager were observed to take large net short positions consistently, for example, a cause for termination might exist.

like those in section 16 creates a presumption that the benefits of section 16 do not outweigh the costs.

## V. SUMMARY AND CONCLUSION

The most important points to understand in order to assess the desirability of insider trading laws are as follows:

1. Both the common law and state law place few, if any, restraints on insider trading. Section 16 of the Securities Exchange Act of 1934 restricts the trading of a select few insiders. Since the 1960's, judicial construction of section 10(b) and Rule 10b-5 has attempted to restrict the trading of employees and tippees based on "material" information. The existing law places no restrictions on transactions involving shares of competitors or trading based on "nonmaterial" information. The empirical evidence suggests that the judicial reinterpretation of section 10(b) as a ban on insider trading has had no detectable effect on insiders' rates of return. The existing laws make an artificial distinction between insiders and outsiders even where the outsiders have dealings with the firm, and these laws fail to constrain the trading activities of "outsiders." Therefore, existing federal regulations ban only a small percentage of trades by individuals with superior information.

2. No evidence suggests that firms generally have attempted to prohibit insider trading or, after 1934, attempted to plug the large gaps in the federal bans against insider trading.

3. The recent articles in the economic literature as well as the older general criticisms that illustrate some possible inefficiencies associated with trading by insiders do not justify the current federal regulations, but rather would justify far broader restrictions on insider trading. Such broader restrictions seem inconsistent with the desires of firms as revealed through their own choices of contractual terms and corporate charter provisions and with the development of state and common law rules.

4. Firms have strong incentives to allocate property rights in valuable information to the highest-valuing user. The absence of widespread prohibitions on insider trading in employment agreements and corporate charters indicates that firms may, in some situations, want to allocate this property right to managers or other employees. We have suggested several information and efficiency effects of insider trading to explain why this might be the case.

5. Even if the property right in information is allocated to the firm, federal regulation of insider trading would be justifiable only if

the federal regulations could enforce contracts against insider trading at a lower cost than private firms or states. The evidence does not conclusively support (or refute) this conclusion.

6. Even if federal regulation is justified on the basis of low enforcement costs, firms should have the opportunity to opt out of the regulation in the absence of any showing of third party effects. Firms are the best judges of how to structure the terms of their employment contracts.

7. The one aspect of existing regulation of insider trading under section 10(b) and Rule 10b-5 that might be desirable is public enforcement of nonconsensual trading based on material information. Because the materiality requirement does not distinguish between consensual and nonconsensual trading, however, it is not efficient.

8. Arguments can also be made in favor of the various provisions of section 16(b). And because the firm is the proper plaintiff in cases brought under this section, the danger of deterring consensual trading is greatly reduced. But the absence of private restrictions and common law rules like those in section 16(b) casts doubt on its desirability.

Based on the available evidence (which admittedly is scanty in some places), it appears that the allocation of the valuable property right in information would be better left to private negotiations and common law development.



