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The Insider Trading Prohibition: A Legal and Economic Enigma

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Abstract: The prohibition of insider trading in U.S. federal securities law typically is justified on fairness or equity grounds. Predictably, these arguments have had little traction in the law and economics community. At the same time, however, law and economics scholars have not coalesced around a single view of the prohibition; instead, competing economic arguments generated an extensive debate that is still active. Those law & economics scholars who favor deregulation of insider trading typically argue that efficiency is the sole basis for analyzing a legal regime, and that the prohibition lacks any rational economic basis. This article critiqued two pro-deregulation arguments: (1) the effect of insider trading on the pricing of securities and (2) the claim that insider trading is an efficient compensation scheme. The article found neither argument persuasive. Those who favor regulating insider trading typically respond either by rejecting the claim that efficiency is the controlling criterion or by attempting to show that the prohibition is justifiable on efficiency grounds. The pro-regulation arguments critiqued herein include: (1) insider trading injures the firm whose securities were traded; (2) insider trading injures shareholders of the firm whose securities were traded; and (3) insider trading violates norms of fairness. In sum, this article contended that neither side had carried the field, but suggested that the argument in favor of regulation probably was winning at the time. The article concludes with some observations on the concept of efficiency as a normative principle.

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THE INSIDER TRADING PROHIBITION: A LEGAL AND ECONOMIC ENIGMA

Stephen Bainbridge[**]

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The law of insider trading is society's attempt to allocate the property rights to information produced by a firm.[1] At early common law insiders were permitted to trade in a

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[*] [Page breaks in original indicated by bold numbers in brackets.]

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[1] On property rights generally, see Demsetz, Toward a Theory of Property Rights, 57 AM. ECON. REV. 347 (1967). On property rights in information, see generally Demsetz, Information

firm's stock without disclosure of inside information, but modern insider trading rules substantially prohibit trading without disclosure.[2] [**36**] Despite significant recent increases in enforcement activity and penalties, insider trading remains the most common violation of the federal securities laws.[3]

Insider trading also remains one of the most controversial aspects of securities law. The prohibition against insider trading is usually justified on grounds of fairness and equity.[4] However, a small, but growing, number of commentators have attacked the prohibition on efficiency grounds. The economic claims favoring insider trading, first articulated by Professor Henry Manne,[5] have produced an extensive debate[6] which is still active.[7]

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and Efficiency: Another Viewpoint, 12 J. LAW & ECON. 1 (1969); Hirshleifer, The Private and Social Value of Information and Reward to Incentive Activity, 61 AM. ECON. REV. 561 (1971).

[2] See infra text accompanying notes 11-61. The federal prohibition includes not only managers and other true insiders but also certain outsiders to whom the information is revealed. See HOUSE COMM. ON ENERGY AND COMMERCE, INSIDER TRADING SANCTIONS ACT OF 1984, H.R. REP. NO. 355, 98th Cong., 2d Sess. 4-5, reprinted in 1984 U.S. CODE CONG. & AD. NEWS 2274, 2277-2278 [hereinafter cited as ITSA REPORT]. However, this article will focus on insider trading by managers. For purposes of this article, management includes both officers and directors. This focus is not without drawbacks, but it pervades the debate. See infra note 218.

[3] See generally Dooley, Enforcement of Insider Trading Restrictions, 66 VA. L. REV. 1, 7 (1980); Note, A Critique of the Insider Trading Sanctions Act of 1984, 71 VA. L. REV. 455 (1985). No solid statistics are available on the incidence of insider trading. Indeed, by the very nature of the activity, measurement of its frequency is probably impossible. However, available evidence indicates the incidence is high. First, studies of the investments made by corporate insiders indicate they consistently out perform all other market actors. See, e.g., Finnerty, Insiders and Market Efficiency, 31 J. FIN. 1141 (1976); Jaffe, Special Information and Insider Trading, 47 J. BUS. 410 (1974). Second, significant increases in the trading volume and price of target shares often precedes announcements of mergers or tender offers. See The Economist, June 30, 1984, at 67; N.Y. Times, June 7, 1984, at D8, col. 1. These factors support the widely held perception that insider trading occurs at a relatively high frequency. Although the evidence suggests insider trading violations are a common, if not the most common, securities violation, their prevalence should not be exaggerated. Relative to the total trading volume, the incidence of insider trading is probably low. See Noble, S.E.C. Chief Plans Insider Trade Curb, N.Y. Times, Oct. 26, 1981, at D1, col. 1, D2, col. 2.

[4] See Scott, Insider Trading: Rule 10b-5, Disclosure and Corporate Privacy, 9 J. LEGAL STUD. 801, 804 (1980). As Professor Scott notes, the SEC justified the prohibition in the seminal decision In re Cady, Roberts & Co., 40 S.E.C. 907 (1961), as necessary to prevent 'the inherent unfairness', of insider trading. See also R. POSNER & K. SCOTT, ECONOMICS OF CORPORATION LAW AND SECURITIES REGULATION 119 (1980) ('Much, if not most, of the judicial discussion of insider trading has been in terms of fairness and equal treatment of all investors.').

[5] See, e.g., H. MANNE, INSIDER TRADING AND THE STOCK MARKET (1966); Manne, In Defense of Insider Trading, HARV. BUS. REV., Nov.-Dec. 1966, at 113 [hereinafter cited as In Defense].

[6] For representative criticism of Professor Manne's thesis, see, e.g., Schotland, Unsafe at Any Price: A Reply to Manne, INSIDER TRADING AND THE STOCK MARKET, 53 VA. L. REV. 1425 (1967); Mendelson, The Economics of Insider Trading Reconsidered (Book Review), 117 U.

Current insider trading law combines high nominal sanctions with very low probabilities of punishment. This enforcement regime is probably rational only [37] when limited enforcement resources are available to deal with a wide-spread problem. Yet, simple fairness requires a rational basis for the prohibition itself. The insider trading debate had focused on the search for this rational basis.[8] The commentators who support deregulation of insider trading ('Deregulators') have argued that efficiency is the sole basis for analyzing a legal regime, and that the prohibition lacks any rational basis under such an analysis. The commentators who favor regulation of insider trading ('Regulators') have responded either by rejecting the claim that efficiency is the controlling criterion or by seeking to show that the prohibition is justifiable on efficiency grounds.[9]

This article examines the arguments favoring and opposing deregulation of insider trading. It concludes that prohibition can neither be fully justified nor rejected on efficiency or fairness grounds. The prohibition thus remains both a legal and economic enigma. Part I contains a brief summary of the current state of prohibition. Part II critiques the arguments favoring deregulation, and seeks to demonstrate that those economic theories fail on their own terms.[10] Part III considers and rejects, in part, the arguments in

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PA. L. REV. 470 (1969). Professor Manne responded to these critiques in Manne, Insider Trading and the Law Professors, 23 VAND. L. REV. 547 (1970).

[7] See Bonner, A Kind Word for Insiders, N.Y. Times, Mar. 21, 1984, at D2, col. 1. The jurisprudence of Law and Economics, which has influenced most pro-insider trading commentators, is one of the most important and controversial modern American legal theories. Applying its principles to the insider trading problem is especially controversial, both within the Law and Economics school and outside it.

For an introduction to economic analysis of law, see generally C. GOETZ, CASES AND MATERIALS ON LAW AND ECONOMICS (1984); A. POLINSKY, AN INTRODUCTION TO LAW AND ECONOMICS (1983); R. POSNER, ECONOMIC ANALYSIS OF LAW (2d ed. 1977). On the controversy over Law and Economics jurisprudence, see, e.g., Kornhauser, The Great Image of Authority, 36 STAN. L. REV. 340 (1984); Mensch, The History of Mainstream Legal Thought, in THE POLITICS OF LAW: A PROGRESSIVE CRITIQUE 18, 36 (D. Kairys ed. 1982); Unger, The Critical Legal Studies Movement, 96 HARV. L. REV. 563, 574 (1983); Note, Efficiency and a Rule of 'Free Contract': A Critique of Two Models and Economics, 97 HARV. L. REV. 978 (1984).

[8] How insider trading should be regulated, if in fact it should be regulated, lies beyond the scope of this article. See generally Levmore, Securities and Secrets: Insider Trading and the Law of Contracts, 68 VA. L. REV. 117 (1982) (summary of five regulatory schemes).

[9] For want of more convenient terms, these groups are identified herein as Deregulators and Regulators, respectively. The use of such labels implies a greater degree of uniformity of position or analysis than in fact exists in either group. Moreover, the use of such terms incorrectly implies that the issue is the choice between making insider trading completely free from restrictions and absolutely prohibiting it. Cf. Schotland, supra note 6, at 1439 ('The Manne thesis miscasts the issue by stating the question in terms of black and white: Shall insider trading be free, absolutely, or banned absolutely? But the appropriate question is whether there should be any restraints, and if so, what restraints?').

[10] The Deregulators usually offer at least two noneconomic arguments against regulation. The first of these is that the current regulatory regime has failed to significantly deter insider trading. See, e.g., Dooley, supra note 3, at 5-28; cf. Note, supra note 3, at 465-72 (discussion of ITSA sanctions and their deterrent nature). Their second and more serious noneconomic argument is that the SEC and the courts established the insider trading prohibition under Rule 10b-5, 17 C.F.R. §

favor of prohibition. Part IV briefly explains the reasons for the failure of the debate to produce a clear answer and examines the implications of that failure.

I. THE INSIDER TRADING PROHIBITION

Originally, insider trading was regulated by state corporate law.[11] State courts developed three approaches in the first three decades of the 1900's to deal with [**38**] the insider trading problem:[12] the insider had no duty of disclosure and could buy freely regardless of any informational advantage (the 'no duty' rule;[13] the insider had no duty in the absence of any 'special circumstances' justifying the imposition of a duty (the 'special circumstances' rule);[14] the insider had a duty to disclose material information when buying stock from shareholders (the 'fiduciary duty' rule).[15] By 1937, the special circumstances rule had become the majority, or at least the plurality, rule and the fiduciary duty rule had been adopted in a substantial minority of jurisdictions.[16] However, both the special circumstances and fiduciary duty rules were limited in application. They were applied only where the insider engaged in face-to-face transactions with existing shareholders. In exchange transactions, the uniform rule was that no duty of disclosure existed.[17]

Although these state common law rules on insider trading are not preempted by federal securities law, federal regulation under the 1934 Securities Exchange Act[18] ('1934 Act') has, for all practical purposes, superseded them. This development occurred not

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240.10b-5 (1983), without statutory authorization. In other words, they assert that in adopting the 1934 Securities Exchange Act Congress did not intend to prohibit insider trading, but rather only to impose a very limited reporting requirement on insiders. See, e.g., Dooley, supra note 3, at 56-62; see also Easterbrook, Insider Trading, Secret Agents, Evidentiary Privileges, and the Production of Information, 1981 SUP. CT. REV. 309, 318-20 ('it is most unlikely that in 1934 Congress intended to create a federal law of fraud'). Neither of these arguments addresses the principal question whether insider trading should be regulated. They serve only to suggest drawbacks in the current regime. Both were remedied in part by the recent adoption of the Insider Trading Sanctions Act of 1984, Pub. L. 98-376, 98 Stat. 1264. See Note, supra note 3, at 465-72, 497-98.

[11] Cf. Smithe, Purchase of Shares of a Corporation by a Director from a Shareholder, 19 MICH. L. REV. 698 (1921) (discussing cases); Walker, The Duty of Disclosure by a Director Purchasing Stock From His Stockholders, 32 YALE L.J. 637 (1923) (same); Wilgus, Purchase of Shares of Corporation by a Director From a Shareholder, 8 MICH. L. REV. 267 (1910) (same). The analysis in this section is drawn in large measure from Note, supra note 3 (by this author).

[12] See generally Berle, Publicity of Accounts and Directors' Purchases of Stock, 25 MICH. L. REV. 827, 833-36 (1927); Lake, The Use for Personal Profit of Knowledge Gained While a Director, 9 MISS. L.J. 427, 445-46 (1937).

[13] E.g., Carpenter v. Danforth, 52 Barb. Ch. 581 (N.Y. 1868). For discussion, see authorities cited infra note 15.

[14] E.g., Strong v. Repides, 213 U.S. 419 (1909). See generally Wilgus, supra note 11 (discussing cases leading up to Strong).

[15] E.g., Dawson v. National Life Ins. Co., 176 Iowa 362, 157 N.W. 929 (1916). For development and debate of the fiduciary duty rule in state courts, see generally Berle, supra note 12; Laylin, The Duty of a Director Purchasing Shares of Stock, 27 YALE L.J. 731 (1918); Smith, supra note 11; Walker, supra note 11; Wilgus, supra note 11.

[16] See generally Lake, supra note 12, at 447-51.

[17] See generally Walker, supra note 11, at 637-41.

[18] 15 U.S.C. §§ 78a-kk (1982).

through congressional legislation but through a process of SEC rule-making and judicial interpretation under section 10b of the 1934 Act.[19] Neither section 10b nor Rule 10b-5 were cited to regulate insider trading until 1961, thirty-seven years after the 1934 Act was passed and nineteen years after the SEC promulgated the rule.[20] Then, in *In re Cody, Roberts & Co.*,[21] Chairman Cary discovered the rule prohibited insider trading. In Cady, Roberts, the Commission held insider trading constituted, at a minimum, fraud or deceit in connection with the purchase or sale of securities,[22] and thus violated Rule 10b-5(C).[23]

Some observers felt that since *Cady, Roberts* was an administrative proceeding [**39**] against a regulated broker-dealer, it was unlikely to presage general application of Rule 10b-5 to insider trading.[24] However, this assumption was shattered in the precedent-breaking 1968 case of *SEC v. Texas Gulf Sulphur Co.*[25] In *Texas Gulf Sulphur*, the Second Circuit held 'anyone in possession of material inside information must either disclose it to the investing public, or, if he is disabled from disclosing it in order to protect a corporate confidence, or he chooses not to do so, must abstain from trading in or recommending the securities concerned while such inside information remains undisclosed.'[26]

Although *Cady, Roberts* and *Texas Gulf Sulphur* represented a significant departure from established SEC and judicial precedent,[27] they were soon followed and refined in a series of cases establishing a federal common law prohibition of insider trading under Rule 10b-5.[28] The elements establishing a violation of the insider trading prohibition were

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[19] Cf. id. § 78j (section 10b of 1934 Act). See generally L. LOSS, FUNDAMENTALS OF SECURITY REGULATION 799-946, 1125-52 (1983); B. RIDER & L. FRENCH, REGULATION OF INSIDER TRADING (1979).

[20] Cf. 17 C.F.R. § 240.10b-5 (1983) (promulgated in 13 Fed. Reg. 8183 (1948)).

[21] 40 S.E.C. 907 (1961).

[22] Id. at 913.

[23] Id.; see Note, supra note 3, at 461.

[24] See Note, supra note 3, at 461.

[25] 401 F.2d 833 (2d Cir. 1968), cert. denied, 394 U.S. 976 (1969).

[26] Id. at 848 (citations omitted).

[27] Prior to Cady, Roberts, the SEC apparently did not view Rule 10b-5 as governing insider trading. See HEARINGS BEFORE THE SENATE COMM. ON BANKING AND CURRENCY ON FACTORS AFFECTING THE BUYING AND SELLING OF EQUITY SECURITIES, 84th Cong., 1st Sess. 964, 1180 (1955) (testimony by Chairmen Demmler and Armstrong); cf. Cook & Feldman, Insider Trading under the Securities Exchange Act, pts. 1 & 2, 66 HARV. L. REV. 385, 612 (1953) (a lengthy and seminal article on insider trading coauthored by then SEC Chairman Cook which does not even mention Rule 10b-5).

[28] See, e.g., Dirks v. SEC, 463 U.S. 646 (1983); Chiarella v. United States, 445 U.S. 222 (1980); United States v. Newman, 664 F.2d 12 (2d Cir. 1981), cert. denied, 464 U.S. 863 (1983); Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228 (2d Cir. 1974). The most important way in which the federal prohibition differs from the state common law is through its applicability to exchange transactions. Compare Texas Gulf Sulphur, 401 F.2d at 833 (applying Rule 10b-5 to exchange transactions) with Goodwin v. Agassiz, 283 Mass. 358, 186 N.E. 659 (1933) (directors not liable for nondisclosure under state law where they bought stock on exchange). A full examination of Rule 10b-5 jurisprudence is beyond the scope of this article. However, it has been thoroughly explored elsewhere. See, e.g., L. Loss, supra note 19, at 799-946, 1125-52.

pointed out by the Supreme Court in *Dirks v. SEC*.[29] First, a relationship must exist which gives the insider access to information intended only for corporate purposes.[30] Second, it must be unfair to allow the corporate insider to take advantage of the information without disclosure.[31] The Court went on to note that the duty of disclosure arises not from mere possession of nonpublic information but from the insider's fiduciary relationship with the corporation or seller of securities.[32]

Despite the establishment of federal prohibitions, the incidence of insider trading continued to rise throughout the 1970's and early 1980's.[33] The frequency of violations has been attributed to the relative mildness of existing sanctions and the low level of SEC enforcement activity. Together, these factors [**40**] produced a virtually no-risk situation for inside trading.[34] The Insider Trading Sanction Act[35] ('ITSA') was adopted to remedy the failure of the pre-ITSA enforcement regime by serving as a powerful deterrent to insider trading abuses.[36] However, the federal common law prohibition will continue to play an important role as the basis for the ITSA's operation and as an ancillary enforcement regime.[37]

Under pre-ITSA law, the SEC had a number of enforcement mechanisms available for use in insider trading cases. These included civil injunctions, disgorgement, administrative proceedings, reports of investigation, and criminal prosecutions.[38] The SEC recognized that despite these sanctions, the enormous profit potential which existed contributed to an increase in the incidence of insider trading. As a result, in 1979, the SEC substantially increased its enforcement activities.[39] Between 1979 and 1981, the SEC charged 33 individuals with insider trading violations.[40]

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[29] 463 U.S. 646 (1983).

[30] Id. at 653.

[31] Id. at 653-54.

[32] Id. at 654.

[33] See N.Y. Times, Jan. 9, 1984, at D5, col. 3; N.Y. Times, Oct. 26, 1981, at D1, col. 1.

[34] See 130 CONG. REC. H7759 (daily ed. July 25, 1984) (statement of Rep. Wirth). Congressman Wirth, author of the House version of the Insider Trading Sanctions Act stated: 'As we have seen by the increased incidences of insider trading, even the SEC's stepped up enforcement program against insider trading has failed to halt the abuses. The SEC simply must have the tools to deal with this problem effectively.' Id.

[35] Insider Trading Sanctions Act of 1984, Pub. L. No. 98-376, 1984 U.S. CODE CONG. & AD. NEWS (98 Stat.) 1264 (to be codified at 15 U.S.C. §§ 78c, 78o, 78t, 78u, 78ff).

[36] See N.Y. Times, Jan. 9, 1984, at D1, col. 2.

[37] See Note, supra note 3, at 491-98.

[38] Other potential enforcement tools include prosecutions under the Mail Fraud statute, 18 U.S.C. § 1341 (1982), or the Racketeering Influenced and Corrupt Organizations Act, 18 U.S.C. § 1962(b) (1982). For a comprehensive discussion of insider trading remedies, see Levine, Ferrigno & Mann, An Assessment of the Law Proscribing Insider Trading after Dirks, in THE NEW FACE OF INSIDER TRADING: Chiarella, Dirks, AND BEYOND 239, 268-80 (ALI-ABA Course of Study 1983); see also Note, supra note 3, at 463-72.

[39] See Note, supra note 3, at 466.

[40] The Economist, supra note 3, at 67.

The emphasis on insider trading increased dramatically with the 1981 appointment of John Shad as SEC Chairman.[41] During his tenure, the number of individuals charged with insider trading offenses amounted to almost one-third of all those prosecuted in the history of the SEC.[42] Moreover, the SEC initiated a vigorous, highly publicized campaign to curtail insider trading.[43] The campaign included not only true corporate insiders, but also such outsiders as a financial printer,[44] an investment analyst,[45] investment bankers,[46] a football coach,[47] and a Wall Street Journal writer.[48] John M. Fedders, the Director of **[41]** Enforcement of the SEC, described these cases as seeking to bring 'everyone including the butcher, the baker, and the candlestick maker' within the prohibition against insider trading.[49]

Although the SEC's stepped up enforcement effort has enjoyed only mixed success,[50] these recent cases have produced an important new theory—misappropriation—for including outsiders within the prohibition.[51] In addition, they represent a new SEC approach to determining insider trading based upon the 'big bang' enforcement theory.[52] Due to limited enforcement resources the SEC has chosen to prosecute high visibility cases in an attempt to maximize the publicity and deterrence resulting from each case.[53] As a result, the ultimate outcome of the case is probably less important to the 'big bang' approach than the publicity surrounding the prosecution.[54] Despite increased enforcement efforts, the SEC recognized the necessity for an increase in the penalties for insider trading to provide greater deterrence.[55] The traditional weapons of injunction and disgorgement had simply proved inadequate.

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[41] Id.; see also N.Y. Times, Oct. 26, 1981, at D1, col. 1.

[42] The Economist, supra note 3, at 67.

[43] N.Y. Times, May 19, 1984, at 31, col. 1.

[44] See Chiarella v. United States, 445 U.S. 222 (1980).

[45] See Dirks, 463 U.S. at 646.

[46] See United States v. Newman, 664 F.2d 12 (2d Cir. 1981), cert. denied, 464 U.S. 863 (1983).

[47] See SEC v. Switzer, 590 F. Supp. 756 (W.D. Okla. 1984).

[48] See SEC v. Brant, FED. SEC. L. REP. (CCH) ¶ 91,571 (S.D.N.Y. July 12, 1984).

[49] N.Y. Times, May 27, 1984, § 3, at 1, col. 2.

[50] The SEC lost Chiarella v. United States, 445 U.S. 222 (1980), Dirks, 463 U.S. at 646, and SEC v. Switzer, 590 F. Supp. 756 (W.D. Okla. 1984). The Commission won United States v. Newman, 664 F.2d 12 (2d Cir. 1981), cert. denied, 464 U.S. 863 (1983). SEC v. Brant, FED. SEC. L. REP. (CCH) ¶91,571 (S.D.N.Y. July 12, 1984), is still in litigation.

[51] Chief Justice Burger first suggested the misappropriation theory in his dissent to Chiarella v. United States, 445 U.S. 222, 239 (1980) (Burger, C.J., dissenting). The Second Circuit adopted the theory in United States v. Newman, 664 F.2d 12, 18 (2d Cir. 1981), cert. denied, 464 U.S. 863 (1983).

[52] N.Y. Times, May 27, 1984, § 3, at 21, col. 3.

[53] Id.

[54] The Wall Street Journal case, SEC v. Brant, FED. SEC. L. REP. (CCH) ¶91,571 (S.D.N.Y. July 2, 1984), forced many newspapers to review their rules on employee ownership of stock and handling of unpublished material. New York Times, May 27, 1984, § 3, at 21, col. 3.

[55] Former Commissioner Thomas observed that '[i]nsider trading has been proliferating at an alarming rate, and we need a new weapon in our arsenal to stem this tide.' N.Y. Times, Sept. 2,

In response to the SEC's requirement, Congress enacted ITSA in 1984. ITSA increases the penalties for insider trading in three major ways.[56] First, ITSA amends section 21(b) of the 1934 Act to give the SEC authority to seek a civil monetary penalty of up to 'three times the profit gained or loss avoided' by the inside trader.[57] Because the SEC is permitted to seek both disgorgement and treble damages, the insider trader now faces potential civil liability of up to four times the profit gained.[58] Second, ITSA amends [**42**] section 32 of the 1934 Act to increase the maximum criminal fine from $10,000 to $100,000.[59] Finally, ITSA amends section 20 to extend insider trading penalties to puts, calls, straddles, options, or privileges.[60]

Adoption of ITSA significantly increases the stakes for inside traders and conclusively establishes a statutory basis for the common law prohibition. However, the number of insider trading convictions remains small in comparison to the number of violations.[61] Consequently, adoption of ITSA has created an enforcement regime which couples large nominal sanctions with low probabilities of enforcement. The result is a system where a very few are punished very severely in order to enforce the prohibition against insider trading.

II. THE ARGUMENT FOR DEREGULATION

Deregulators contend the central question for insider trading jurisprudence is whether the firm's owner would consent to insider trading by the firm's agents. The Deregulators assert that if insider trading is efficient, shareholders would permit it. If shareholders would permit it, society should acquiesce to that decision.

The Deregulators identify two principal ways in which insider trading benefits the firm.[62] First, they suggest insider trading causes the market price of the affected security to move toward the price which the security would command if the inside information were publicly available. This theoretically benefits society and the firm through increased price accuracy. Second, they argue insider trading is an efficient way of compensating managers for having produced information. This theoretically benefits the firm by giving managers a greater incentive to produce additional information of value to the firm.

A. *The Effect of Insider Trading on the Price of Securities*

1982, at D1, col. 1. Although Chairman Shad is similarly supportive of ITSA, he cautioned that one should not overexaggerate the incidence of insider trading, which he suggests is minimal in comparison to the volume of trading. See N.Y. Times, Oct. 26, 1981, at D1, col. 2.

[56] ITSA also amended section 15(c)(4) of the 1934 Act thereby permitting the SEC to conduct administrative proceedings against violators of section 14 of the Act. See ITSA § 4.

[57] ITSA § 2. A person violates the prohibition 'by purchasing or selling a security while in the possession of material nonpublic information.' Id.

[58] See Note, supra note 3, at 471.

[59] ITSA § 3. The increase in the amount of the fine applies not only to insider trading violations but to all securities law violations. Id.

[60] ITSA § 5.

[61] See Note, supra note 3, at 489-90.

[62] For noneconomic arguments of Deregulators, see supra note 10.

Both Deregulators and Regulators agree society substantially benefits from accurate pricing of securities.[63] The 'correct' price of a security is that which would be set by the market if all information relating to the security had been publicly disclosed.[64] Accurate pricing benefits society by improving the economy's allocation of capital investment and by decreasing the volatility of security prices.[65] This dampening of price fluctuations decreases the likelihood of individual windfall gains and increases the attractiveness of investing in securities [43] for risk-adverse investors.[66] The individual corporation also benefits from accurate pricing of its securities through reduced investor uncertainty and improved monitoring of management's effectiveness.[67] Finally, investors as a class benefit by receiving the full value of their investment.

The federal securities laws encourage accurate pricing by requiring disclosure of corporate information. However, they do not require the disclosure of all material information. Where disclosure would interfere with legitimate business transactions, disclosure by the corporation is usually not required unless a firm is dealing in its own securities at the time.[68] This rule is often justified on efficiency grounds. Discovery of new information can produce substantial social gains. However, unless the discoverer is permitted to realize the profits of the discovery, the incentive to produce such information is reduced. The law permits a firm to withhold new information when necessary to preserve the incentive to produce information.[69]

Where a firm is permitted to withhold material information, its securities are no longer accurately priced by the market. If the undisclosed information is particularly significant, the error in price can be substantial. For example, in the *Texas Gulf Sulphur* case,[70] Texas Gulf Sulphur (TGS) discovered an enormously valuable mineral deposit in Canada. When the deposit was discovered, TGS common stock sold for approximately eighteen dollars per share.[71] By the time the discovery was disclosed, four months later, the price had risen to over thirty-one dollars per share.[72] One month after disclosure, the stock was selling for approximately fifty-eight dollars per share.[73] These large errors eliminate the benefits of accurate pricing. However, disclosure would reduce the value of

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[63] Compare Carlton & Fischel, The Regulation of Insider Trading, 35 STAN. L. REV. 857, 866 (1983) (Deregulators) with Wang, Trading on Material Nonpublic Information of Impersonal Stock Markets, 54 S. CAL. L. REV. 1217, 1226 (1981) (Regulator).

[64] Cf. Gilson & Kraakman, The Mechanisms of Market Efficiency, 70 VA. L. REV. 549, 554 (1984) (A market is 'efficient' when 'prices at any time 'fully reflect' all available information.').

[65] See Carlton & Fischel, supra note 63, at 866; Wang, supra note 63, at 1226.

[66] Wang, supra note 63, at 1226.

[67] Carlton & Fischel, supra note 63, at 867.

[68] See Brudney, Insiders, Outsiders, and Informational Advantages Under the Federal Securities Laws, 93 HARV. L. REV. 322, 337 (1979).

[69] See Dooley, supra note 3, at 63; Levmore, supra note 8, at 133-37. See generally Kronman, Mistake, Disclosure, Information, and the Law of Contracts, 7 J. LEGAL STUD. 1 (1978).

[70] Texas Gulf Sulphur, 401 F.2d at 833.

[71] Id. at 840 n.2.

[72] Id. Presumably the gradual rise in price was due to intervening insider trading, and the final price after disclosure approximately reflected the value of the discovery. Id.

[73] H. MANNE, supra note 5, at 81.

the information and thus the incentive to discover it. The Deregulators argue insider trading is an effective compromise between the need for preserving incentives to produce information and the need for maintaining accurate securities prices.

Professor Manne uses the following example to demonstrate this effect. A firm's stock currently sells at fifty dollars per share. The firm has discovered new information that, if publicly disclosed, would cause the stock to sell at sixty dollars. If insiders trade on this information, the price of the stock will gradually rise toward but will not reach the 'correct' price. Absent insider trading or leaks, the stock's price will remain at fifty dollars until the information is publicly disclosed and then rapidly rise to the correct price of sixty dollars. Thus, insider [**44**] trading acts as a replacement for public disclosure of the information, preserving market gains of correct pricing while permitting the corporation to retain the benefits of nondisclosure.[74]

Texas Gulf Sulphur would appear to provide empirical evidence of this effect. The TGS insiders began active trading in its stock almost immediately after discovery of the ore deposit. During the four months between discovery and disclosure, the price of TGS common stock gradually rose by over twelve dollars.[75] Arguably, this price increase was due to inside trading.

The Deregulators argue that since the goal of market efficiency[76] is promoted by insider trading, deregulation is justified.[77] By this analysis, the profits which the insider derives from trading are the price society pays for obtaining the beneficial effects on market efficiency.[78]

Recognizing insider trading may promote market efficiency does not necessarily compel the conclusion that inside trading should be deregulated. The profits an insider can derive from trading on nonpublic information are potentially enormous. For example, Thomas C. Reed, a former special assistant to President Reagan, allegedly learned of a proposed takeover of Amax Inc., and purchased $3,125 worth of Amax options. The next day the bid was announced and Mr. Reed exercised his options, yielding a profit of $427,000.[79]

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[74] Id. at 80-90; see also In Defense, supra note 5, at 113; Carlton & Fischel, supra note 63, at 867-68.

[75] Texas Gulf Sulphur, 401 F.2d at 840 n.2.

[76] An efficient market is one in which prices fully reflect all available information. For an introduction to modern efficient capital market theory, see Gilson & Kraakman, supra note 64; see also Note, The Efficient Capital Market Hypothesis, Economic Theory and the Regulation of the Securities Industry, 29 STAN. L. REV. 1031 (1977).

[77] Professor Friedman observes: 'One school [the Deregulators] believes that it is impossible for a corporation to keep the market constantly informed about significant changes in corporate affairs, so efficient market[s] are furthered by insider trading which operates to 'channel additional information to the market' less directly [than full public disclosure].' Friedman, Efficient Market Theory and Rule 10b-5 Nondisclosure Claims: A Proposal for Reconciliation, 47 MO. L. REV. 745, 753 (1982) (quoting Wu, An Economist Looks at Section 16 of the Securities Exchange Act of 1934, 68 COLUM. L. REV. 260, 266 (1968)); see also Heller, Chiarella, SEC Rule 14e-3 and Dirks: 'Fairness' Versus Economic Theory, 37 BUS. LAW. 517, 531-32, 539-40 (1982).

[78] Heller, supra note 77, at 533.

[79] N.Y. Times, May 17, 1983, at D2, col. 1.

Although such windfalls are uncommon, profits of fifty to a hundred percent are made routinely by insiders trading on advance knowledge of changes in profits or dividends.[80] Generally, insiders outperform market returns by two to eight percent.[81] These substantial gains are justifiable only by a significant improvement in market efficiency.

Furthermore, the empirical evidence and theoretical basis for the Deregulators' claims is, at best, inconclusive. Early market studies indicated insider trading had an insignificant effect on price in most cases.[82] Subsequent studies have suggested the market reacts fairly quickly when insiders buy securities, [**45**] but the price effect is minimal when insiders sell.[83] The most recent empirical study found that while transactions by insiders were followed by a strong price effect, the transactions were only rarely based on exploitation of nonpublic information.[84] If this study is correct, then the market efficiency rationale for deregulation loses much of its force: insider trading simply is not communicating inside information to the market.

Efficient Capital Market theory also gives, at best, only weak support to the Deregulators' market efficiency argument. The argument is that when insiders have access to unfavorable inside information, they will sell. The number of securities on the market increases and drives down the price.[85] In truth, however, the effect of insider trading on the supply or demand for a security probably has only a minimal impact on its price. The security 'represents only a particular combination of expected return and systematic risk, for which there is a vast number of substitutes.'[86] The correct measure for the supply of securities is not simply the total of the firm's outstanding securities, but the vastly larger number of securities with a similar combination of risk and return. Therefore, the supply effect of the relatively small number of insider trades cannot have a significant price effect.[87]

The price effect of insider trading is an example of what Professors Gilson and Kraakman call the 'derivatively informed trading mechanism' of market efficiency.[88] Derivatively informed trading affects market prices through a two-step mechanism. First, those individuals possessing material nonpublic information begin trading. Their trading has only a small effect on price. Some uninformed traders become aware of the insider trading through leakage or tipping of information or through observation of insider trades. Other traders gain insight by following the price fluctuations of the securities. Finally, the market reacts to the insiders' trades and gradually moves toward the correct price.[89] The problem is that while derivatively informed trading can affect price, it func-

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[80] N.Y. Times, Apr. 13, 1983, at D1, col. 3.

[81] Scott, supra note 4, at 807.

[82] See Schotland, supra note 6, at 1443.

[83] See Finnerty, supra note 3.

[84] Givoly & Palmon, Insider Trading and the Exploitation of Inside Information: Some Empirical Evidence, 58 J. BUS. 69 (1985).

[85] See Gilson & Kraakman, supra note 64, at 629.

[86] Id. at 630.

[87] Id.; Easterbrook, supra note 10, at 335-37.

[88] Gilson & Kraakman, supra note 64, at 630.

[89] Id. at 572-79.

tions slowly and sporadically.[90] Given the inefficiency of derivatively informed trading, the market efficiency justification for insider trading loses much of its attractiveness.

Even if it were clear that insider trading significantly enhanced market efficiency, reliance on market efficiency alone as a basis for reform is suspect. Efficient markets do exist, and the securities market is a nearly perfect ex-[**46**]ample.[91] However, there is no complete theoretical explanation of why they exist. Until an understanding of efficient markets is developed, reforms intended to promote efficiency risk upsetting the conditions which made the market efficient in the first place.[92]

B. *Insider Trading as an Efficient Compensation Scheme*

Even Professor Manne has admitted that price effect is not a strong argument against a bar on insider trading.[93] However, he believes there is a much better argument. Manne contends allowing insider trading profits is the only effective means of compensating entrepreneurs in large corporations.[94]

Manne distinguishes the entrepreneurial role of corporate agents from that of corporate managers. A manager simply operates the firm according to predetermined guidelines.[95] Since the firm and the manager know what the manager will do and what his abilities are, salary is an appropriate method of compensation. For an agent, however, salary is only appropriate when the value of the agent's services are known in advance.

The entrepreneur's contribution to the firm consists of the production of new information that is valuable to the firm. The entrepreneur's compensation must have a reasonable relation to the value of his contribution to give him incentive to produce more information. Since it is rarely possible to ascertain the information's value to the firm in advance, predetermined compensation, such as salary, is inappropriate for entrepreneurs.[96]

The entrepreneur could of course be compensated through bonuses. However, Professor Manne argues that the bonus plan also fails to adequately compensate entrepreneurs. He gives five reasons for rejecting bonus compensation. First, courts may reject corporate bonus plans. Second, compensation plans must be publicly disclosed, and some executives may not desire the publicity. Third, the entrepreneur and the firm may not be able to agree on the value of his contribution. Fourth, a bonus is paid annually, but the

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[90] Id. at 631. Professors Gilson and Kraakman suggest that insider trading could be used effectively as a mechanism of market efficiency if insiders were allowed to trade but were required to disclose their trades immediately. See id. at 632-34. However, they stress that '[i]nformational efficiency is not itself enough to justify lifting the prohibition on insider trading.' Id. at 634 n.224. See infra text accompanying note 92.

[91] A vast body of empirical evidence is available supporting the claim that the capital markets are efficient. See generally Note, supra note 76, at 1041-57.

[92] See id. at 553.

[93] H. MANNE, supra note 5, at 110.

[94] In Defense, supra note 5, at 114.

[95] Id. at 116.

[96] Id.

innovation may produce returns over may years. Fifth, when a firm is losing money, it is unlikely to pay substantial bonuses even if the innovation holds down losses.[97]

Professor Manne asserts insider trading is an effective way to compensate corporate agents for innovations. The increase in the price of the security following public disclosure provides an imperfect but comparatively accurate measure of the value of the innovation to the firm. The entrepreneur can recover the value of his discovery through buying the firm's securities prior to disclosure and selling them after the price rises.[98]

[**47**] Professors Carlton and Fischel have suggested a further refinement of Manne's compensation argument.[99] They also believe advance payment contracts fail to compensate managers for innovations. The firm could renegotiate these contracts later to account for innovations, but renegotiation is expensive and thus may not occur frequently enough to provide appropriate incentives for entrepreneurial activity.[100] Carlton and Fischel suggest that one of the advantages of insider trading is that a manager is able to change his compensation package without continually renegotiating his contract.[101] By trading on the new information, the manager self- tailors his compensation to account for the information he produces, increasing his incentive to develop valuable innovations. Since insider trading provides the manager with more certainty of reward than other compensation schemes it also provides more incentives.[102]

In evaluating the compensation justification for inside trading, it is crucial to recognize that when an agent produces information, the property right to that information belongs to the principal.[103] However, information differs from most forms of property in that, once produced, it may be used by many parties without being depleted. Thus, the principal could use the information while also allowing the agent to use the information as compensation for producing it

Deferring for the moment the question of whether a corporation would ever encourage its managers to use insider trading as compensation,[104] the Deregulators' argument is overbroad. In many cases, insider trading would lower the value of the information to the firm.[105] In such cases, the firm would prefer to pay compensation rather than permit insider trading. A particularized rule permitting insider trading where trading would not lower the value of the innovation to the firm could be adopted. However, particularized rules can impose other costs including potentially substantial uncertainty and tertiary costs.[106] A general rule, whether absolutely permitting or prohibiting insider trading, might be less costly.

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[97] H. MANNE, supra note 5, at 135.

[98] Id. at 116-19; see also id. at 138-41; Manne, supra note 6, at 578- 79.

[99] See Carlton & Fischel, supra note 63, at 869.

[100] Id. at 869-70.

[101] Id. at 870.

[102] Id. at 870-71.

[103] See supra text accompanying note 1.

[104] See infra text accompanying notes 121-51 (discussing this issue).

[105] See infra text accompanying notes 122-31.

[106] See Note, supra note 7, at 981. Tertiary costs are the costs of administering the dispute resolution system. See Note, Trade Usages in International Sales of Goods: An Analysis of the 1964 and 1980 Sales Conventions, 24 VA. J. INT'L L. 619, 650 (1984).

Virtually no empirical evidence in the literature exists to indicate which rule would be most efficient. A number of considerations, however, suggest insider trading is an inefficient form of compensation. Several factors contribute to this inefficiency.

One of Professor Manne's objections to contractual or bonus forms of compensation is that they fail to accurately measure the value of the innovation to the firm and so fail to adequately compensate the insider for his efforts.[107] It [**48**] is far from clear, however, that insider trading is any more accurate. Even assuming the change in stock price accurately measures the value of the innovation, the insider's compensation is limited by the number of shares he can purchase. This, in turn, is limited by his wealth. Professor Manne responds to this point simply by noting that innovators are not often fully compensated for the value of their innovations. Manne suggests that allowing insider trading guarantees a particular form of compensation but not a particular amount.[108]

Professor Mann's response implicitly contradicts his earlier assertion that insider trading is more accurate than other compensation plans.[109] Second, it ignores the point that the insider's trading returns are based, not on the value of his contribution, but on his wealth.[110] A Deregulator might respond by arguing that the insider can borrow money to purchase shares. However, this simply changes the determinative factor from wealth to access to credit; it does not make his compensation reflect the value of the contribution.

Another objection to the compensation argument is the difficulty of restricting trading to those who produced the information. The information's production costs are normally much greater than distribution costs. Thus, unless the manager withholds the information from colleagues until after trading, many firm employees may trade on the information without having contributed to its production. Such self-policing delay imposes significant costs on the firm.[111]

A third objection to insider trading as compensation is based on its contingent nature. Because the manager's trading returns cannot be measured in advance, neither can the true cost of his reward. As a result, selection of the most cost-effective compensation package is made more difficult.[112] Moreover, the manager himself may prefer a less uncertain compensation package. If a manager is risk adverse, he would likely 'prefer the certainty of $100,000 salary to a salary of $50,000 and a ten percent chance of a bonus of $500,000'[113] from insider trading. The manager will value the 'bonus' at $50,000 but, if he collects, it will cost the shareholders the full $500,000. Thus, both the shareholders

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[107] See In Defense, supra note 5, at 117-19.

[108] Id. at 119.

[109] Compare id. ('When we view insider trading as an appropriate form of compensation rather than a device for accurately valuing innovations . . .') with id. at 118 ('The increase in stock price [from insider trading] . . . will provide as accurate a gauge of the value of the innovation as can be found . . .').

[110] See Schotland, supra note 6, at 1455. Professor Schotland asks: 'Why should the innovating entrepreneur, who happens to have inherited wealth, profit much more from his 'entrepreneurial' acts than his equally creative colleague who inherited nothing?' Id. at 1455 n.84.

[111] See infra text accompanying notes 122-28.

[112] Levmore, supra note 8, at 150.

[113] Easterbrook, supra note 10, at 332.

and the manager could gain by exchanging a guaranteed bonus for the manager's agreement not to trade on inside information.[114]

Unrestricted insider trading is therefore an ineffective stimulant for productive managerial efforts. The profits an insider derives from trading are not related to the insider's contribution to the firm's performance. Further, insider trading replaces other compensation systems which are more beneficial to the [**49**] company. As a result, shareholders do not know in advance how much they are actually paying for managerial services and, thus, cannot make cost-effective choices on how to run the firm.[115]

Insider trading has a number of other drawbacks as a compensation scheme. It may harm the corporation, either directly or indirectly through giving management perverse incentives. It permits the insider to trade on bad news, creating incentive to produce bad news. Finally, it gives managers an incentive to manipulate stock prices.[116]

As with the market efficiency argument, little empirical evidence supports or counters the compensation argument.[117] The only useful empirical evidence is Professors Givoly and Palmon's recent finding that while insiders do earn abnormal returns from trading in their firm's securities,[118] these abnormal returns are based on the insiders' superior assessment of their firm's status and not on exploitation of inside information.[119] If so, the compensation argument rests on fundamentally flawed assumptions.

III. THE ARGUMENT FOR REGULATION

The Deregulators' argument, in essence, is that insider trading by innovative managers benefits both the firm and society. It promotes market efficiency and creates efficient incentives for the manager to make further innovations. The Regulators' response is two-fold. First, they claim insider trading is not a cost-effective mechanism for promoting market efficiency and is no more effective than other compensation plans at producing the right incentive for entrepreneurial managers. Second, the Regulators argue that even if the Deregulators are correct as to market efficiency and compensation, insider trading still creates such substantial social costs and fairness concerns[120] that it should be prohibited.

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[114] Id. But see Carlton & Fischel, supra note 63, at 876-77.

[115] Levmore, supra note 8, at 149-50.

[116] These arguments are not only part of the Regulators' rebuttal to the Deregulators' compensation argument but also part of their broader argument against insider trading. See infra text accompanying notes 120-214.

[117] One empirical argument frequently made by Deregulators is that if shareholders objected to insider trading compensation, they could and would require the firm to prohibit insider trading, but few firms have done so. Thus, the argument runs, shareholders do not object to insider trading and so society should also permit it. See infra text accompanying notes 206-14.

[118] Givoly & Palmon, supra note 84, at 76 (finding an abnormal rate of return for insider transactions of 8.0%).

[119] Id. at 85.

[120] As discussed infra text accompanying notes 159-205, the fairness issue is controversial even among the Regulators. Some Regulators join the Deregulators in rejecting fairness as a basis for prohibiting insider trading, but differ with the Deregulators on the efficiency issues. There

A. *Insider Trading Injures the Firm and Its Shareholders*

Three groups may be injured by insider trading: the firm, its shareholders, and the investors who trade with the insider. The latter group overlaps with [**50**] the second to a considerable extent. When the insider buys stocks, all those with whom he trades are firm shareholders; when he sells, the buyers may be shareholders or outsiders. Deferring for the moment the question of whether those who trade with the insider are injured by trading,[121] this section examines the Regulators' argument that insider trading injures the firm and shareholders, whether they trade or not.

1. Internal Delay and Distrust

Decisionmaking in any entity requires accurate, timely information. In large, hierarchical organizations, such as most publicly traded corporations, information must pass through many levels before reaching senior managers. The more levels, the greater the probability of distortion or delay intrinsic to the system. This inefficiency can be reduced by downward delegation of decisionmaking authority but not eliminated. Even with only minimal delay in the upward transmission of information at every level, where the information must pass through many levels before reaching a decisionmaker, the net delay may be substantial.[122] Corporate decisionmaking may be significantly impaired through such untimely information. Moreover, increasing the period between the production of the information and its utilization by the firm increases the likelihood that outsiders will discover the information and use it, reducing its value to the firm. Insider trading may injure the firm by creating incentives for managers to delay the transmission of information to superiors. If the manager discovers or obtains information (either beneficial or detrimental to the firm), he may delay disclosure of that information to other managers so as to assure himself sufficient time to trade on the basis of that information before the corporation acts upon it. As noted, even if the period of delay by any one manager is brief, the net delay produced by successive trading managers may be substantial.[123]

A second way in which insider trading may impede corporate decisionmaking is by creating distrust and ill-will among the firm's top decisionmakers. Studies of group decisionmaking have shown that trust among group members is crucial to effective decisionmaking. When members are distrustful, relevant information is often distorted or concealed. As a result, the decisions reached are likely to be inaccurate, untimely, or not

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Regulators presumably would accept deregulation if convinced that the efficiency arguments justified it. See, e.g., Easterbrook, supra note 10, at 338 ('I have paraded a series of arguments, mostly economic, for and against insider trading . . .. The arguments are closely balanced. Although I think it likely that legal restrictions on such trading are beneficial, the questions ultimately are empirical. I may be singing a different tune tomorrow.').

[121] See infra text accompanying notes 199-205.

[122] This analysis is drawn primarily from Haft, The Effect of Insider Trading Rules on the Internal Efficiency of the Large Corporation, 80 MICH. L. REV. 1051, 1053-60 (1982). As Professor Haft points out, there may be as many as fifteen management levels in a large corporation. Id. at 1053.

[123] Inside trading may also create incentives for the firm's agents to delay disclosure to the public, thereby impeding market efficiency. See infra text accompanying notes 152-58.

sufficiently comprehensive.[124] Distrust encourages group members to expend efforts to verify information provided by other group members and to be suspicious of their behavior, reducing the quality of decisionmaking.[125]

[**51**] Professor Haft suggests that if the decisionmakers chose to cooperate in the pursuit of trading profits rather than compete for them, the problems of distrust might be reduced.[126] However, it seems unlikely that members of a conspiracy to engage in wrongful conduct would be more likely to trust one another and refrain from acting strategically than would a group cooperating in achieving legal and appropriate goals. The prevalence of strategic behavior in legitimate transactions—such as one group member 'holding out' for a large share of the cooperative pie—suggests the likelihood of cooperative behavior by a group of inside traders is small.[127] Hence, whether directors and managers compete or cooperate in pursuit of trading profits, the effect of insider trading on their group dynamics is probably negative.[128]

2. Interference With Corporate Plans

Insider trading may significantly interfere with corporate plans. A classic example of this effect is insider trading during the planning stages of a merger. If insiders, knowing the firm intends to make a tender offer for some target firm, buy shares in the target, the price of the target's shares may rise through derivatively informal trading and/or leaks, making the takeover more expensive.[129] More generally, insider trading activity might tip off others to the presence of some secret, reducing the value of the secret to the firm and interfering with the firm's exploitation of it.[130]

This objection is less serious than some other proregulation arguments. Given the relatively small effect insider trading normally has on stock prices,[131] trading (in the absence of tipping) would probably not interfere significantly with corporate opportunities. At any rate, interference sufficient to seriously disrupt corporate plans would be proscribed by the business opportunity doctrine.[132] Therefore, an additional prohibition against insider trading would not be necessary in this case.

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[124] Haft, supra note 122, at 1062.

[125] Id.

[126] Id. at 1063.

[127] Cf. A. POLINSKY, supra note 7, at 7, at 18-20 (problem of strategic behavior in nuisance cases); Carlton & Fischel, supra note 63, at 874 (managers likely to follow strategies that maximize value of firm).

[128] Professor Haft suggests a further drawback to cooperative pursuit: it would destroy the value of having 'independent' directors by giving them incentives to become part of the firm hierarchy. See Haft, supra note 122, at 1063-64.

[129] See Carlton & Fischel, supra note 63, at 884; see also Easterbrook, supra note 10, at 331.

[130] Kitch, The Law and Economics of Rights in Valuable Information, 9 J. LEGAL STUD. 683, 719 n.89 (1980); see Easterbrook, supra note 10, at 331.

[131] See supra text accompanying notes 82-90.

[132] See generally Kitch, supra note 130, at 683-716 (legal theories for protection of corporate information).

3. High-Risk Projects

Although insider trading may not cause the firm to lose opportunities, a number of Regulators suggest it creates incentives for management to alter firm plans in less drastic ways to increase the likelihood and magnitude of trading profits. For example, trading managers can accelerate receipt of revenue, change [52] depreciation strategy, or alter dividend payments in an attempt to affect share prices and insider returns.[133] Alternatively, the insiders might structure corporate transactions to increase the opportunity for secret-keeping. Both types of decisions may adversely affect the firm and its shareholders. Moreover, Professor Levmore suggests this incentive may result in overinvestment in industries or activities which generate more opportunities for trading on nonpublic information.[134] If so, insider trading would cause significant misallocation of social resources.

Professor Easterbrook identifies a related 'perverse incentive' of insider trading.[135] He suggests managers may elect to follow policies that increase fluctuations in the price of the firm's stock. 'They may select riskier projects than the shareholders would prefer, because if the risks pay off they can capture a portion of the gains in insider tradings and, if the project flops, the shareholders bear the loss.'[136]

Professors Carlton and Fischel assert that Easterbrook overstates the incentive to choose high-risk projects. Because managers must work in teams, the ability of one or a few managers to select high-risk projects is severely constrained through monitoring by colleagues.[137] Cooperation by enough managers to pursue such projects to the firm's detriment is unlikely because a lone whistle-blower is likely to gain more by exposing others than he will by colluding with them.[138] Further, Carlton and Fischel argue managers have strong incentives to maximize the value of their services to the firm. Therefore they are unlikely to risk lowering that value for short-term gain by adopting policies detrimental to long-term firm profitability.[139]

The first part of Carlton and Fischel's argument seems well founded. Undoubtedly, group dynamics limit managers' ability to choose high-risk projects. Their second point is less persuasive. In an earlier collaboration with Professor Easterbrook,[140] Fischel recognized the virtual impossibility of removing incumbent management without its consent.[141] Indeed, tender offers are the one practical method of doing so within the market for corporate control.[142] Where the corporate control market functions effectively, man-

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[133] Brudney, supra note 68, at 335 n.53.

[134] Levmore, supra note 8, at 149.

[135] Easterbrook, supra note 10, at 332.

[136] Id.; see also Gilson & Kraakman, supra note 64, at 632 n.221.

[137] Carlton & Fischel, supra note 63, at 876.

[138] Id. at 874.

[139] Id. at 876.

[140] Easterbrook & Fischel, The Proper Role of a Target's Management in Responding to a Tender Offer, 94 HARV. L. REV. 1161 (1981).

[141] See id. at 1170-71.

[142] The 'market for corporate control' is the mechanism through which inefficient corporate managers are replaced by more efficient management. The most advantageous takeover method is the tender offer process. Shareholders sell their shares to an offeror who gains control of the firm and typically ousts the incumbent management. See Fishel, Efficient Capital Market Theory, the

agement has a strong incentive to maintain the value of the firm. If management permits the firm's share [**53**] price to fall through its wrongdoing or negligence, the shareholders will sell to an offeror who will oust the incumbents.

However, where the market for corporate control is inefficient, management can permit the firm's value to fall with substantially less risk of a successful tender offer. Most commentators, including Fischel, agree that the market does not function efficiently, due to management defensive tactics as well as federal and state regulation.[143] Carlton and Fischel's point assumes a well-functioning corporate control market, and is therefore suspect. To the extent incumbent management is permitted to ward off tender offers and thus protect itself from ouster, the incentive to maintain the value of its services by abstaining from high-risk projects is reduced.

Even if the market for corporate control functioned efficiently, it might not impose sufficient restraint on management. If a target's managers earn excessive compensation by insider trading, the target's attraction to potential buyers may rest, in part, on the possibility that their managers stand to gain the same opportunity after acquisition. Eliminating insider trading after a takeover might benefit the shareholders through an increase in share price; on the other hand, the acquiring company managers, by foregoing the opportunity for insider trading, would bear the entire cost. For this reason, the market for corporate control may operate only to shift, rather than to eliminate, the opportunity for excessive compensation between managers.[144]

Carlton and Fischel alternatively argue that even if insider trading creates incentives for management to choose high-risk projects, these incentives are not necessarily harmful.[145] The incentives act as a counterweight to management's intrinsic aversion to risk-taking which tends to cause managers to select low-risk projects. Such balancing is said to benefit shareholders.[146]

Carlton and Fischel are correct that shareholders may prefer higher- risk projects. Because shareholders hold residual claims, they will prefer that the firm invest in projects with a significant upside potential. This is true even if such ventures pose a substantial risk because shareholders earn no return until all prior claims are paid.[147] However, shareholder would not approve high-risk projects where the increased risk is not matched by a commensurate increase in potential return. Allowing insider trading encourages management to select 'negative net present value investments,' as shareholders bear the full risk of failure.[148] As a result, shareholders would probably prefer other incentive plans to achieve the desired result without encouraging downside risks.

Market for Corporate Control, and the Regulation of Cash Tender Offers, 57 TEX. L. REV. 1 (1978).

[143] See Easterbrook & Fischel, supra note 140; Fischel, supra note 142; see also Gilson, A Structural Approach to Corporations: The Case Defensive Tactics in Tender Offers, 33 STAN. L. REV. 819 (1981).

[144] Gilson & Kraakman, supra note 64, at 632 n.221.

[145] Carlton & Fischel, supra note 63, at 875.

[146] Id. at 875-76.

[147] See W. KLEIN, BUSINESS ORGANIZATION AND FINANCE 122-25 (1979).

[148] See Gilson & Kraakman, supra note 64, at 632 n.221.

4. Manipulation

Manipulation, as a form of fraud, harms both society and individuals [54] by decreasing the accuracy of pricing by the market. The Regulators argue that if managers are permitted to trade on inside information they have a strong interest in keeping the stock pricing stable or to move it in the 'correct' direction while they are trading. Therefore, they have a strong incentive to use manipulative practices.[149]

Professor Manne, for the Deregulators, acknowledges manipulation is harmful and that manipulation of stock prices would cease if insider trading could be effectively eliminated because nobody would then benefit from it.[150] Manne's principal response to the manipulation argument is not that it is wrong, but the costs of producing perfect compliance with a prohibition against insider trading are unacceptably high.[151] Like some arguments in this debate, the thrust of the manipulation rationale depends on whose estimate of the costs is correct.

B. *Delay*

Despite the strong bias in the federal securities laws towards prompt disclosure of material developments, many circumstances arise in which a firm is permitted to delay disclosure. For example, a firm may delay disclosure when it could be preempted by competitors or would otherwise be unable to take advantage of the development. This type of delay reduces market efficiency, but is justified because prompt disclosure in such circumstances would reduce the firm's incentive to produce socially valuable information.

The loss of market efficiency due to delayed disclosure, however, requires the delay be no longer than necessary for the firm to capture the development's value. Any additional delay introduces serious social costs without counterbalancing returns. Unnecessary delay also harms the firm by requiring expenditure of resources to protect the information from 'snooping' and leaks.[152] To the extent delay reduces market efficiency, the firm suffers additional losses.[153] The Regulators argue insider trading causes additional delay and therefore should be prohibited.[154]

Deregulators point out insider trading may also produce incentives to release information promptly, allowing others to use the information before its value is lost.[155] Of course, conversely, insider trading may create incentives to release information too early,

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[149] Schotland, supra note 6, at 1449-50.

[150] Manne, supra note 6, at 575.

[151] Id.; see also In Defense, supra note 5, at 119. Manne also criticizes Schotland for what Manne calls his failure 'to say anything meaningful about manipulation.' Manne, supra note 6, at 575.

[152] See Easterbrook, supra note 10, at 333.

[153] See Carlton & Fischel, supra note 63, at 867.

[154] See, e.g., Brudney, supra note 68, at 334 n.43; Easterbrook, supra note 10, at 333; Levmore, supra note 8, at 149-50; Schotland, supra note 6, at 1448-49. The related problem of internal delay, see supra text accompanying notes 122-28, may also extend delay of public disclosure, further exacerbating the cost of delay.

[155] See, e.g., Manne, supra note 6, at 553.

thereby harming the firm. However, the Deregulators correctly point out that the ultimate empirical question is whether delay, early disclosure, or timely disclosure will occur more frequently.[156]

[**55**] The empirical evidence is scanty. Professor Dooley's 1980 study of the 37 reported insider trading decisions between 1966 and 1980 showed that in only one case was disclosure delayed.[157] Although Dooley's results suggest delay is not an important problem, his sample is statistically insignificant in comparison to the incidence of insider trading. During that period, the ratio of cases brought to actual insider trading events was almost certainly greater than one in sixty.[158] Thus, the empirical reality remains uncertain.

Even if occurring only infrequently, the delay may still be important. Any delay harms the firm, its shareholders, and society. While regulation cannot completely prevent delay without enforcement costs which are unacceptably high, deregulation might significantly increase the incentives for delay by removing any deterrent.

C. *Fairness*

The final prong of the Regulators' argument against insider trading focuses on its unfairness. The Regulators contend insider trading causes rational investors to refrain from trading, to incur search costs to avoid the insider's informational advantage, and to demand premiums as compensation for the risk of insider trading. Both the individual investor and society as a whole are therefore injured by insider trading.

1. Is Insider Trading Unfair?

Traditionally, the most common argument against insider trading has been that it is unfair. Fairness arguments regarding insider trading frequently appear to rely on some unarticulated notion that it is unfair because it is inherently 'sleazy.' This intuitive judgment must be given substantive content to be an appropriate basis for legal rule-making. Fairness can be defined in three principal ways: fairness requires that no trader breach a fiduciary duty by trading; fairness requires that no trader possess an informational advantage; and, fairness requires that the trader not harm those with whom he trades.[159]

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[156] See, e.g., Carlton & Fischel, supra note 63, at 879; Dooley, supra note 3, at 34.

[157] Dooley, supra note 3, at 34; see SEC v. Shattuck Denn Mining Corp., 297 F. Supp. 470 (S.D.N.Y. 1968) (involving delay in release of information).

[158] See Flood of Insider Trading Referrals to SEC Results in Trickle of Investigations, Lawsuits, [July Dec.] SEC. REC. & L. REP. (BAN) No. 412, at A- 4, A-5 (July 20, 1977). Between 1974 and 1976 the major stock exchanges and the National Association of Securities Dealers reported 186 suspected insider trading events to the SEC. The SEC investigated only 20% of these cases, and in only one case in sixty was an action brought. Id. Moreover, since a large number of cases undoubtedly remained undetected, the ratio is probably even smaller. See generally Note, supra note 3, at 489.

[159] This division is a modified version of that used by Professor Fasterbrook. He divides fairness arguments into four categories: fairness as identical returns, fairness as the ability to trade at the right price, fairness as the absence of wealth transfers, and fairness as equality of information. Easterbrook, supra note 10, at 323-30. The analysis used here modifies Easterbrook's by merging his first and second categories into the argument that no trader should harm those with whom he

[**56**] a. Fairness as Fidelity

The modern prohibition of insider trading, in large measure, rests on the duty of an agent not to use confidential information for personal profit. In dealing with a principal the agent is required to disclose all material facts.[160] For an agent to profit by dealing with an uninformed principal would be unfair because the agent is already compensated for his efforts.[161] Moreover, the general rule is efficient because the cost of allowing non-disclosure exceeds the benefit of increased incentive to produce information.[162]

The dispute between the Regulators and the Deregulators is not over the validity of the general rule, but rather over its application to insider trading. Regulators argue the insiders acquired the information in their capacity as fiduciaries of the shareholders, and thus may not use it is dealings with the shareholders.[163] If insider trading is permitted, the shareholders will either demand a premium to compensate for the risk imposed or will expend resources policing management. Prohibiting insider trading thus prevents 'a costly breach of a fiduciary duty.'[164]

Various arguments against applying the general rule to insider trading have been made. Easterbrook, for example, argues that any duty analysis is essentially circular: the law finds a duty not to act when an underlying analysis suggests the activity should be banned. Duty-based analyses, therefore, are essentially conclusory, and should not play an important role in policy-making.[165]

Carlton and Fischel base their analysis on the theory that insider trading is a legitimate means of compensation. All forms of compensation benefit the agent at the expense of the principal. Because insider trading is an efficient means of compensation, shareholders would voluntarily permit it and no independent fairness notions would justify a prohibition.[166] The difficulty with their argument is most compensation plans affect shareholders equally, while insider trading affects shareholders differently.[167] Additionally, there are good reasons to doubt the claim that insider trading is an efficient compensation scheme.[168] Hence, rational shareholders could well not agree to it.

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trades, and by merging the concept of fiduciary duty, which he treats separately from fairness, see id. at 317-23, into his third category.

[160] See Dirks v. SEC, 463 U.S. 646 (1983); Chiarclla v. United States, 445 U.S. 222 (1980). See generally RESTATEMENT (SECOND) OF AGENCY § 395 (1958).

[161] For an analysis of this duty in the context of going private transactions, which, to a certain extent, can be considered the most extreme form of insider trading, see Brudney & Chirelstein, A Restatement of Corporate Freezeouts, 87 YALE L.J. 1354, 1365-70 (1978).

[162] Dooley, supra note 3, at 64.

[163] Brudney, supra note 68, at 344.

[164] Id. at 336.

[165] Easterbrook, supra note 10, at 321-22.

[166] Carlton & Fischel, supra note 63, at 881-82; see also Easterbrook, supra note 10, at 328-39.

[167] Easterbrook admits this point but suggests that it is a species of the fairness as equal returns argument. Easterbrook, supra note 10, at 328.

[168] See supra text accompanying notes 103-16; see also Brudney, supra note 68, § 345.

Professor Dooley makes a more sophisticated argument against imposing a duty not to trade on inside information. His initial proposition is that efficiency, [**57**] not fairness, is the correct justification for the general rule.[169] Use of information by an agent produces agency costs, but these costs are only significant if the agent tries to appropriate the full value of the information. In the large publicly held firm it would be impossible for the insider to do so and most of the benefits of the information will go to the firm and its shareholders.[170] Apparently, Dooley assumes that allowing insider trading creates incentives to produce valuable new information that outweigh the limited agency costs imposed.[171]

b. Fairness as Equality of Information

The fiduciary duty rationale for prohibiting insider trading has dominated judicial discussion and academic commentary since *In re Cady, Roberts & Co*.[172] The notion that insider trading is unfair because the insider has a material informational advantage has also attracted a number of important adherents. However, judicial acceptance has been less enthusiastic.

Equality of information, a favorite argument of some regulators,[173] was recently rejected by the Supreme Court. In *Chiarella v. United States*,[174] the Court held the trader's fiduciary duty and not his informational advantage was the basis for a violation of the rule.[175] The Court expressly reaffirmed this holding in *SEC v. Dirks*.[176] However, the legislative history of the recent Insider Trading Sanctions Act[177] contains several refer-

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[169] Dooley, supra note 3, at 64.

[170] Id. at 64-66.

[171] See id. Dooley's argument is worthy of further explanation. If partners in a small firm can withhold new information from each other, then each has an incentive to drive the other out and take full advantage of the information. As each seeks to exclude the other, the value of the firm declines. A legal rule vesting the firm with a property right to the information and requiring disclosure is more efficient than forcing the partners to draft disclosure agreements and monitor one another's behavior. The partners would still have incentives to produce information because they would share in its value to the firm. As no one will withhold information, the productivity of the firm will be maximized. The same considerations of cost to the firm do not apply in publiclyheld corporations. If an insider attempts to buy up stock, the market price will rise. The rise reflects the value of the information and draws attention to it, resulting in disclosure. Thus, insiders cannot exclude all others from sharing in the benefit of new information. Insider trading does not conflict with the interests of the corporation and its shareholders. Id.

[172] 40 S.E.C. 907 (1961).

[173] See, e.g., Brudney, supra note 68, at 339-40, 346; Loss, The Fiduciary Concept as Applied to Trading by Corporate 'Insiders' in the United States, 33 MOD. L. REV. 34 (1970); Schotland, supra note 6, at 1451; cf. Levmore, supra note 8, at 122 (defining fairness as 'equal positions').

[174] 445 U.S. 222 (1980).

[175] Id. at 232-33.

[176] 463 U.S. 646, 654 (1983).

[177] Pub. L. No. 98-376, 1984 U.S. CODE CONG. & AD. NEWS (98 Stat.) 1264 (to be codified at 15 U.S.C. §§ 78c, 780, 78t, 78u, 78ff); see supra text accompanying notes 33-61.

ences to the unfairness of informational advantages as a rationale for the Act.[178] The role of equality of information as a legal basis for the rule thus remains in question.

Using equality of information as a rationale for regulating insider trading would [**58**] justify punishing trading by any person who possesses material nonpublic information. This 'mere possession test' would be much broader than the current prohibition, and would be inconsistent with both the policies and equities underlying the securities statutes.[179] A mere possession test would also be inconsistent with general contract rules permitting informational advantages under many circumstances.[180] Consequently, some Regulators[181] have recognized that equality of information must serve, at most, only a limited role in justifying regulation.

For Professor Brudney, an informational advantage is unfair when the investor cannot independently and lawfully acquire the same information.[182] He focuses on equality of access to information, not equality of possession. Because inside information belongs to the firm, the investor cannot lawfully acquire it prior to disclosure. The insider's abuse of his greater access 'generates a sense of unfairness' in the investor because he can never overcome the insider's advantage, despite his diligence.[183] Other informational advantages can be overcome through diligence and effort and, thus, do not generate the same sense of unfairness.

One Deregulator response to the equality of information position is based on the Efficient Capital Market Theory. The market's response to insider trading protects uninformed investors by quickly bringing the price to the level the market would set if the information were publicly disclosed.[184] This 'market fairness' position ignores the sense of unfairness generated in the individual investor who trades before the price becomes 'correct.' It also assumes the market responds accurately to insider trading, an assumption which is, at least, questionable.[185]

In responding to Brudney's equality of access argument, Easterbrook contends an informational advantage is not a function of access or lack of access to information. Rather, it is a function of the cost of information. For an outsider to acquire the same information

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[178] See, e.g., ITSA REPORT, supra note 2, at 9; 130 CONG. REC. S8912 (daily ed. June 29, 1984) (remarks of Sen. D'Amato); 129 CONG. REC. S3865 (daily ed. Mar. 23, 1983) (remarks of Sen. D'Amato).

[179] See Note, supra note 3, at 493-96.

[180] For thoughtful and useful analyses of when one party should be permitted to trade despite an informational advantage, see Kronman, supra note 69, at 9-32; Levmore, supra note 8, at 132-44.

[181] See, e.g., Brudney, supra note 68, at 339-43.

[182] See id. at 332-34, 346.

[183] Id.

[184] See Easterbrook, supra note 10, at 329-30; Friedman, supra note 77, at 758-59; Heller, supra note 77, at 525-26. Heller also argues that any '[p]ossible unfairness to individual investors who do not possess the [relevant] information and who may have suffered a pecuniary loss may be outweighed by the benefit to the larger number of investors of the operation of an efficient market.' Id. at 526. This cost-benefit analysis suffers from the same drawbacks as the 'market fairness' argument. See infra next accompanying note 185.

[185] See supra text accompanying notes 82-92.

that a manager has will require him to pay a higher price. A manager will generally know more than a shareholder about corporate business, but this is simply a result of the division of labor. Unless this division of labor is unethical, possession of different amounts of inside knowledge as a result is not unfair.[186] However, granting that the division [**59**] of labor itself is not unfair, Brudney criticizes not the division of labor but the abuse of the manager's different position within the firm. It is the abuse of the results of the division of labor which is unfair.

c. Fairness as Noninjury

A third possible definition of fair dealing is that one should 'do for others what you want them to do for you.'[187] Whether insider trading is unfair in this sense depends on whether those who trade with the insiders are harmed.[188] Insider trading is said to harm the investor in three ways: his trades are made at the 'wrong price'; he is induced to make a bad purchase or sale; he is preempted from making beneficial trades.[189]

An individual investor who trades in a security while material information is undisclosed is injured if he sold at the wrong price. However, it is unclear whether non-insiders as a group are injured. For example, if a firm's stock currently sells at $10 per share, but after disclosure of the new information will sell at $15, a shareholder who sells at the current price has suffered a $5 loss. The insider who purchases the share obtains a corresponding $5 gain. Yet, any outsider who buys stocks on the day the investor sells also gets a $5 gain per share.

If insider trading causes the price of the stock to rise to $12, the outsiders who buy at $12 are injured because they receive only a $3 gain instead of the $5 gain they would have received, but the shareholders receive a $2 gain instead of no gain. In either case, as a group, non-insider transactions essentially wash unless the insider's trade constitutes a significant percentage of total trading.[190] Furthermore, to call the investor's injury unfair when shares are bought by the insider, but not when the outsider without access to the information buys, is essentially a restatement of the informational disadvantage position

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[186] Easterbrook, supra note 10, at 330. Professor Brudney's argument has also been criticized as being overbroad. See Note, Drawing the Line on Insiders and Outsiders for Rule 10b-5: Chiarella v. United States, 4 HARV. J.L. & PUB. POL'Y 203, 227-33 (1981). This criticism, while perhaps valid with regard to regulating insider trading by nonmanagers, does not reach the unfairness of trading by managers. See id. at 232-33.

[187] Matthew 7:12 (Today's English Version).

[188] In addition to fairness concerns, insider trading injuries may impose economic costs that also make it undesirable. See infra text accompanying notes 199-205.

[189] See Wang, supra note 63, at 1235-40. Professor Wang argues inside trades may preempt similar transactions rather than induce opposite transactions. An inside trade may change a market-maker's inventory, thereby affecting price quotations. An increase in inventory may result in lower price quotations to encourage purchases and deter sales to the market-maker. A decrease in inventory may bring an increase in price quotations to deter purchases and increase sales. Id. at 1236. Professor Levmore has proposed a unique argument for a fourth type of injury, based on lost nontrading opportunities. See Levmore, supra note 8, at 146-47, 150-51.

[190] See Schotland, supra note 6, at 1434.

and adds little to that argument. The injury can only be completely avoided by requiring the firm to immediately disclose information, a step the law has been unwilling to take.[191]

The second argument is that inside trading generates price movements which [**50**] induce investors to buy or sell at the wrong time.[192] Assuming insider trading has an effect on prices, this inducement argument still raises a number of questions.[193] The initial issue is the extent to which investors consider price in making investment decisions. Manne argues investors should be divided into two categories: investors, 'whose market decisions will be a function of time,' and traders, 'whose decisions will be a function of the price of the security.'[194] He argues investors make investment decisions based on factors including dividend history, corporate growth, or management reputation, while traders make decisions entirely upon recent price fluctuations.[195]

In contrast, Schotland argues price is the major factor in all investment decisions. He notes that price changes following insider trades induce other investors to enter the market.[196] However, Dooley contends it is unrealistic to suppose all investors who entered the market of the insider trading did so as a result of that trading. Some investors were probably misled by the insider trading. Yet, those most likely to be sensitive to price fluctuations are sophisticated traders. They know full well that price changes may be attributable to insider trading and thus are least in need of protection.[197]

Even if price were a factor, to project how that factor would play out is difficult. For any given group of investors who decide to sell because of a price rise, another group may decide to defer a planned sale in anticipation of further increases. Thus, it seems un-

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[191] See Easterbrook, supra note 10, at 326-27.

[192] Dooley, supra note 3, at 34. Most commentators have focused on the price effect in considering the inducement argument. See, e.g., Schotland, supra note 6, at 1447-48. Professor Wang suggests insider trading induces investors to trade because the insider transactions affect the market-maker's inventory. This results in changes in the market-maker's price quotations and transactions. See Wang, supra note 63, at 1236.

[193] An additional problem with the inducement argument is the practical difficulty of identifying those who are actually injured. See Wang, supra note 63, at 1236-38.

[194] H. MANNE, supra note 5, at 94-95.

[195] In Defense, supra note 5, at 114. Professor Manne further argues that even if short-term investors, as opposed to long-term investors, are misled by price changes into trading when they should refrain, the law should not protect them. He analogizes such investors to gamblers, and asserts that 'it is seriously disturbing to find the SEC pressing hard for a rule designed either to aid this group or encourage their gambling proclivities.' Id. While the argument that insider trading does not induce the investor to trade seems well-taken, this second argument is less convincing. Gamblers expect to be protected from the house using loaded dice, but insider trading amounts to the use of loaded dice by the insider because of his informational advantage. Scott, supra note 4, at 807-08; Schotland, supra note 6, at 1453. Even though speculators using price-based strategies almost certainly can never outperform the market, see Gilson & Kraakman, supra note 64, at 555; Note, supra note 76, at 1034-44; see generally Fama, Efficient Capital Markets: A Review of Theory and Empirical Work, 25 J. FIN. 383, 389-96 (1970), speculators are no less deserving of protection than larger term investors. See Schotland, supra note, 6 at 1453.

[196] Schotland, supra note 6, at 1447. Schotland further argues that even if price is not an important factor in the investor's decisions, the investor is still harmed by the price error introduced by insider trading. Id. at 1447-48.

[197] Dooley, supra note 3, at 35-36; see also In Defense, supra note 5, at 114.

likely price changes will necessarily induce investors to sell to their detriment either as a class or as individuals. Accordingly, the fairness as noninjury position is reduced to the claim that unfairness occurs [**61**] when the investor trades at the wrong price which, as noted, is the same as the informational advantage argument.[198]

2. Reduced Investor Confidence

Having argued insider trading is perceived by investors as unfair, the Regulators next contend that if it is permitted, investors will lose confidence in the market and will refrain from trading or demand a premium (or pay less) when buying stock in a firm where insiders trade.[199] If a firm's management gains a reputation for insider trading, its share price will fall, raising its cost of capital.[200] Moreover, some investors may flee the market, raising the cost of capital for all firms.[201]

The Deregulators first respond by noting the difficulty for investors to distinguish those firms where insider trading is frequent from those where it is infrequent.[202] Second, when the investor can distinguish between such firms, as where there is a publicized case of insider trading within the firm, the investor may discount the price he is willing to pay.[203] However, even though the investor can protect himself, the firm's cost of capital will still rise if investors demand a premium as a result of insider trading.

Whether investors actually demand a premium is an unanswered question. In the absence of empirical evidence, Carlton and Fischel make a number of theoretical observations on the market flight argument. First, they note insider trading has no logical or substantial effect on liquidity. If insiders are prevented from trading, non-insiders would simply expend more money to discover inside information. Those more able to obtain the information, brokers for example, would reap the benefits. Informed brokers would replace informed insiders. The level of trading which occurs suggests investors are sufficiently comfortable with the flow of information to remain in the market.[204]

Their argument is not completely persuasive. The fact that trading occurs does not mean some investors do not leave the market. Any market flight will marginally increase the cost of capital. Moreover, trading currently occurs under a regime prohibiting, if not fully deterring, insider trading and under which insider trading, while the most frequent securities violation, is relatively infrequent in comparison to the total trading volume.[205] Deregulation might significantly increase the level of market flight.

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[198] Cf. Schotland, supra note 6, at 1450-52 (long-term investor is injured). Schotland's argument makes most sense if interpreted as an objection to informational advantages, not price error.

[199] See Brudney, supra note 68, at 356; Mendelson, supra note 6, at 477-78; Wang, supra note 63, at 1229, 1947. This argument formed part of the legislative rationale for the adoption of ITSA. See, e.g., 129 CONG. REC. S3865 (daily ed. Mar. 24, 1983) (remarks of Sen. D'Amato).

[200] Mendelson, supra note 6, at 477-78.

[201] Brudney, supra note 68, at 353-56.

[202] Dooley, supra note 3, at 41.

[203] Id. at 40.

[204] Carlton & Fischel, supra note 63, at 879-80; see also id. at 880 n.76.

[205] See supra note 3.

[**62**] D. *The Deregulator's General Rebuttal: Why Don't Firms Prohibit Insider Trading If It Is So Bad?*

The Regulators insist insider trading imposes substantial costs on society, the firm, shareholders, and investors; accordingly, it should be prohibited or at least regulated. The Deregulators offer specific responses to each of the Regulator's arguments. The Deregulators also have a general argument against regulating insider trading: 'If insider trading is undesirable, why do not firms voluntarily curtail the practice?'[206]

Professor Dooley, among others,[207] observes private firms have not generally taken a strong stand against insider trading. This is a curious position for corporations to assume if insider trading actually has a negative impact on the value of their securities and the confidence of their shareholders. Firms could easily take steps to curtail insider trading by distributing sensitive information only on a 'need to know' basis, demanding abstention from insider trading as a condition of employment, or bonding employees. Yet, most have not done so.[208]

Professor Haft argues firms have not bonded against insider trading because those who would propose corporate restrictions are also those who benefit from insider trading.[209] If one believes the market for corporate control does not restrict management's ability to benefit itself at the firm's expense,[210] this argument is plausible.

Equally plausible but more positive reasons exist for the apparent lack of extensive bonding by firms. For example, public enforcement of a prohibition is probably more efficient than private enforcement in this context. Insider trading is extremely difficult to detect; virtually the only effective means of detection is through computerized monitoring of the markets by the exchanges and the SEC.[211] Collective enforcement may therefore be considerably more efficient, perhaps explaining the absence of private bonding.[212] The recent finding by Professors Givoly and Palmon which indicates insider trades are only rarely based on exploitation of inside information[213] may provide a further ex-

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[206] Easterbrook, supra note 10, at 333.

[207] See, e.g., Carlton & Fischel, supra note 63, at 858.

[208] Dooley, supra note 3, at 45-46. Professor Dooley observes that only two types of firms actually bond against insider trading—lawyers and financial printers—and asks why they bond when other firms do not. His answer is based on the increased value of confidentiality within such firms. Id. at 49-50. For a recent economic analysis of why shareholders would not impose sanctions on trading insiders, see Dye, Insider Trading and Incentives, 57 J. BUS. 295 (1984).

Many firms attempt some regulation of insider trading by senior officers and directors. Louis, The Unwinnable War on Insider Trading, FORTUNE, July 13, 1981, at 72, 74. This was probably only a belated response to the adoption of the federal prohibition, however. See Carlton & Fischel, supra note 63, at 858; Louis, supra, at 74; cf. 15 U.S.C. § 78p (1982) (requiring insiders report their transactions to SEC).

[209] Haft, supra note 122, at 1058.

[210] See supra text accompanying notes 142-43.

[211] See Louis, supra note 208, at 76-78; N.Y. Times, Apr. 13, 1984, at D1, col. 4.

[212] See Easterbrook, supra note 10, at 333-35; Gilson & Kraakman, supra note 64, at 634 n.224. But see Carlton & Fischel, supra note 63, at 863-65, 890-91.

[213] See Givoly & Palmon, supra note 84, at 85.

[**63**]planation for the absence of corporate bonding: there simply is not sufficient need for it.[214]

IV. THE INSIDER TRADING DEBATE: WHY NO ANSWER?

The present insider trading prohibition combines an extremely low probability of conviction with extremely high nominal sanctions. As a result, a small number of violators are severely punished in order to provide deterrence. Such an enforcement scheme may well be necessary where only limited detection and prosecution resources are available. Simple fairness, however, would seem to require that such a regime be justified by a sound normative basis for the underlying prohibition. The debate over the insider trading prohibition has centered on that precise issue—whether the prohibition can be justified on efficiency and/or fairness grounds. Although, at least to this author, the theoretical arguments of the Regulators seem slightly more compelling, as this article has sought to demonstrate, the debate has failed to provide either a fully satisfactory justification for the prohibition or a persuasive case for deregulation. The failure can be traced to the lack of empirical data and the overly narrow normative focus of the debate.

A. *The Empirical Problem*

As Justice Brennan recently observed, cost/benefit analysis without empirical data creates a false illusion of technical precision.[215] Few debates illustrate the Justice's point better than the insider trading controversy. At least twelve points of disagreement within the debate can be identified:

(1) To what extent does insider trading act as an efficient substitute for public disclosure of material nonpublic information?

(2) Is insider trading an efficient compensation scheme?

(3) Does insider trading create incentives for intra-firm delay or distrust?

(4) Does insider trading interfere with corporate plans?

(5) Does insider trading create incentives for managers to select high-risk projects?

(6) Does insider trading create incentives for managers to manipulate the price of the firm's securities?

[**64**] (7) Does insider trading result in delayed or accelerated disclosure of information?

(8) Is insider trading a breach of the manager's fiduciary duties?

(9) Does insider trading injure those with whom the manager trades?

(10) Will insider trading reduce investors' confidence in the securities markets?

(11) Why don't firms bond against insider trading?

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[214] Of course, their findings may also indicate that the current emphasis on insider trading is misplaced. Givoly and Palmon suggest that reconsideration of the techniques and goals of trading regulation may be necessary if the abnormal returns to insiders result from the response to insider trading by investors. Id. at 71.

[215] United States v. Leon, 104 S. Ct. 3405, 3430 (1984) (Brennan J., dissenting) (fourth amendment case).

(12) If the benefits of insider trading exceed the costs, do independent considerations of fairness justify a prohibition nonetheless?

Commentators appear on both sides of virtually every argument, stating their positions with great authority.[216]

Although the validity of the arguments on both sides depends on empirical assumptions about the magnitude of the costs and benefits of insider trading, little empirical evidence exists to support or refute the arguments. Only with regard to the market efficiency argument is there significant empirical data, and these studies are largely inconclusive.[217] Further, those completed empirical studies have primarily focused on insider trading by managers and directors of the firm whose stocks are traded. However, much, if not most, insider trading seems to be done by 'constructive insiders,' outsiders who have a fiduciary relationship with the firm.[218] Any attempt to deal empirically with the problem must also consider these traders to be fully explanatory.

In the absence of conclusive empirical evidence, the arguments on both sides are little more than intuitive, ad hoc judgments about the relative balancing [**65**] of costs and benefits.[219] Without a solid, pervasive body of empirical data the debate cannot be resolved: to many issues arising at the core of the debate rest on mere assumption. Unfortunately, the very nature of insider trading makes this empirical work extremely difficult.[220] Hence, it is unlikely sufficient empirical data to resolve the debate will be available in the near future.

Where empirical evidence is unavailable, some scholars have turned to formal, mathematical modeling. A number of such studies have been done on the insider trading problem.[221] These studies, however, are unlikely to provide much insight into the debate.

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[216] The disagreement between Professors Carlton and Fischel and Professor Easterbrook vividly illustrates this point. Professors Easterbrook and Fischel have been frequent coauthors. See, e.g., Easterbrook & Fischel, Voting in Corporate Law, 26 J.L. & ECON. 395 (1983); Easterbrook & Fischel, Auctions and Sunk Costs in Tender Offers, 35 STAN. L. REV. 1 (1982); Easterbrook & Fischel, Corporate Control Transactions, 91 YALE L.J. 698 (1982); Easterbrook & Fischel, Takeover Bids, Defensive Tactics, and Shareholders' Welfare, 36 BUS. LAW. 1733 (1981); Easterbrook & Fischel, supra note 140.

[217] See supra text accompanying notes 82-84. The recent study by Professors Givoly and Palmon, supra note 84, has implications that extend beyond the maket efficiency argument, but the full implications of their work are still unclear. See supra text accompanying notes 118-19, 213-14.

[218] See Note, supra note 3, at 486 (listing the numerous categories of individuals prosecuted for insider trading). The focus on management throughout the debate is another way in which the debate has failed to be fully explanatory. Few would question the proposition that outright theft of information, such as that of Vincent Chiarella, see Chiarella v. United States, 445 U.S. 222 (1980), should be punished. Through application of the misappropriation theory, such behavior is a principal target of the prohibition. See supra note 51 and accompanying text. The debate has generally ignored this aspect of the problem, further weakening its power as a tool of justification or condemnation.

[219] Cf. Note, supra note 7, at 989 (making the same point with regard to the debate over the free contract rule).

[220] See supra note 3.

[221] See, e.g., Dye, supra note 208.

Formal economic models, by their very nature, must make restrictive assumptions. These assumptions deprive the models of explanatory power, both because the correctness of the assumptions can be questioned and because the world is rarely as simple as the assumptions suggest.[222]

If fully persuasive empirical or modeling studies are not forthcoming, the debate will remain unresolved. Of course, the debate has not been useless. Rather, it has sharpened and focused the issues decisionmakers must consider as the insider trading prohibition continues to develop. Most importantly, the debate reminds decisionmakers that action, such as adopting new sanctions, may involve social costs and fairness concerns which must be considered.

B. *The Normative Problem*

The normative focus of the debate has generally been on efficiency goals; however, the normative claims of economic analysis have been highly controversial.[223] There are essentially two dominant forms of the normative claim. The 'Chicago School'[224] believes that allocative efficiency—variously defined as Pareto optimality, Pareto superiority, potential Pareto superiority (Kaldor-Hicks efficiency), or wealth maximization—is both an appropriate ethical norm and the only one courts are competent to implement.[225] A second form, the 'liberal school,' accepts allocative efficiency as a starting point for normative analysis, but posits that distributional and 'Other Justice' concerns are equally appropriate and necessary components of the discourse.[226]

[**66**] The focus on allocative efficiency in both schools of economic analysis rests on what Professor Kornhauser has termed the 'behavioral claims' of Law and Economics.[227] Economic analysis is a quintessentially instrumentalist jurisprudence and in Kornhauser's view, instrumentalism[228] and the 'behavioral claim'[229] are closely linked. Like the societal

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[222] See Note, supra note 7, at 995.

[223] Full treatment of the normative claim, which has produced an extensive debate in the literature, is beyond the scope of this paper. Probably the best introductions to the debate are Symposium on Efficiency as a Legal Concern, 8 HOFSTRA L. REV. 485 (1980), and A Response to the Efficiency Symposium, 8 HOFSTRA L. REV. 811 (1980).

[224] The label 'Chicago School' results from the initial dominance of this faction of the Law and Economics movement by faculty at the University of Chicago Law School.

[225] The most detailed presentation of this view is given in R. POSNER, THE ECONOMICS OF JUSTICE (1981); see also Posner, The Ethical and Political Basis of the Efficiency Norm in Common Law Adjudication, 8 HOFSTRA L. REV. 487 (1980); Posner, Utilitarianism, Economics, and Legal Theory, 8 J. LEGAL STUD. 103 (1979).

[226] See G. CALABRESI, THE COST OF ACCIDENTS 24-26 (1970); Calabresi, About Law and Economics: A Letter to Ronald Dworkin, 8 HOFSTRA L. REV. 553 (1980); Calabresi & Melamed, Property Rules, Liability Rules, and Inalienability: One View of the Cathedral, 85 HARV. L. REV. 1089 (1972).

[227] Kornhauser, supra note 7, at 353-54.

[228] Id. at 362. 'Instrumentalism, for purposes of this essay, implies that some person or group of persons consciously selects legal rules to channel the behavior of others.' Id. at 361.

[229] 'The Behavioral claim asserts, first, that legal rules affect individual behavior and, second, that economic theory explains how legal rules affect behavior.' Id. at 353.

goals which legitimate the law and consequent legal rules, instrumentalism lends credibility to behavioral theory.[230] Additionally, Kornhauser maintains instrumentalism cannot be accepted without behavioral theory. Guesses based on intuition are inherently less reliable than informed predictions founded on economic theory.[231] Economic theory is thus regarded as the best (and by some the only valid) tool of legal decisionmaking.

Nevertheless, Congress,[232] the SEC,[233] academics,[234] and perhaps industry leaders[235] have repeatedly emphasized the (noneconomic) unfairness and immorality of insider trading. In contrast, among commentators on both sides of the debate, only Professor Dooley explicitly recognizes insider trading 'is behavior that falls below a standard of conduct to which many, including himself , aspire.'[236] Instead, the dominant position seems to be that efficiency, not fairness, is the primary policy consideration.[237]

The emphasis on efficiency is based on the assumption that if insider trading is efficient, shareholders will voluntarily permit it.[238] Several difficulties with this assumption have already been noted.[239] Three further deficiencies can also be identified. First, the assumption ignores third party effects. Even if shareholders would permit insider trading, the law might not if insider trading creates significant costs to third parties. Although it is difficult to show that nonshareholders, as a group, are always injured by insider trading, individual outsiders clearly are.[240] Moreover, insider trading generates nonmonetary costs, chiefly [67] a sense of unfairness resulting from the inability of the outsider to overcome the insider's informational advantage.[241] Fairness viewed as a cost can legitimately serve as a justification for regulation.[242]

The second deficiency with the Chicago School's position is that it ignores distributional concerns. Implicit in the prohibition of insider trading is a distributional decision by both Congress and the courts that the gains from new information should go to investors and not to managers. The merits of the decision may be debatable, but by focusing

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[230] Id.

[231] Id.

[232] See, e.g., ITSA REPORT, supra note 2, at 2-5.

[233] See Memorandum of the Securities and Exchange Commission in Support of the Insider Trading Sanctions Act of 1982, reprinted in ITSA REPORT, supra note 2, at 21.

[234] See, e.g., Schotland, supra note 6, at 1439.

[235] A 1961 poll of business executives indicated that a large proportion did not consider insider trading immoral or unethical. Baumhart, Problems in Review, HARV. BUS. REV., July-Aug. 1961, at 6 (finding that 42% of those polled would trade on the basis of material nonpublic information). See generally Wang, supra note 63, at 1245-47. Because Baumhart's survey preceded the promulgation of the federal prohibition and the resulting debate, its conclusions are at least suspect and may no longer represent the dominant view of executives.

[236] Dooley, supra note 3, at 55.

[237] See, e.g., Carlton & Fischel, supra note 63, at 880-82; Easterbrook, supra note 10, at 323-30. See generally supra text accompanying notes 159-205.

[238] See supra text accompanying note 166.

[239] See supra text accompanying notes 167-68.

[240] See supra text accompanying notes 199-201.

[241] See supra text accompanying notes 190-91.

[242] See generally Calabresi & Melamed, supra note 226, at 1113-14.

solely on allocative efficiency, the Chicago scholars have written off an important portion of the debate.

A further problem with using allocative efficiency as the sole criterion for debate reflects on the behavioral claim. By asserting that rational shareholders would permit insider trading if efficient, the commentators assume rationality is coextensive with self-wealth maximization. They assume no rational shareholder would be so revolted by the 'sleaziness' of insider trading that he would refuse to permit it. This assumption seems plausible in the market context in which insider trading occurs, but its general application to legal rules may be less plausible.

In large part, failure to consider external costs as well as fairness and distributional concerns is a result of the absence of 'liberal school' commentators from the debate. Such failure also demonstrates the limitations of Chicago School analysis. The Chicago approach makes sense only if allocative efficiency is the sole instrumentalist goal of adjudication. This goal cannot be justified on purely economic grounds without reference to external moral and philosophical theories.[243] The Law and Economics scholars who reject the Chicago approach typically do so because they make a different value judgment: a judgment that the proper goal of law is a 'just' society, which requires an appropriate mix of allocative efficiency, wealth distribution and 'Other Justice' concerns.[244] Of course, the liberal school's value judgments also cannot be justified solely on economic grounds.

The disagreement between the Chicago and liberal schools is not solely related to the goals of law, but also to the ideal process of adjudication. The Chicago school believes judges are good only at furthering allocative goals, while the liberal school finds difficulty in explaining judicial decisionmaking solely by reference to allocative efficiency.[245] Thus, the final problem with the Chicago focus on allocative efficiency is that such a focus ignores the possibilities offered by alternative modes of analysis. In the insider trading context, for example, studies which examine who benefits from prohibition causes may offer significant insight into the nature and effect of prohibition. Until these studies are ac-[**68**]complished, the prohibition against and the arguments for deregulation of insider trading will continue to rest upon undemonstrated assumptions.

V. CONCLUSION

Despite a lengthy and active debate, the insider trading prohibition remains both a legal and economic enigma. No fully satisfactory theory has emerged either to explain or condemn the prohibition. The absence of a satisfactory justification for the prohibition is particularly disturbing in light of the high nominal sanctions and low probability of en-

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[243] See Kornhauser, supra note 7, at 354, 358. Judge Posner has attempted to justify his wealth maximization norm through consent arguments. See R. POSNER, supra note 225, at 88-103; Posner, The Ethical and Political Basis of the Efficiency Norm in Common Law Adjudication, 8 HOFSTRA L. REV. 487, 488-502 (1980). For a useful critique of Posner's argument, see Bebchuk, The Pursuit of a Bigger Pie: Can Everyone Expect a Bigger Slice?, 8 HOFSTRA L. REV. 671 (1980).

[244] See Calabresi, supra note 226, at 558-59.

[245] See id. at 561.

forcement. This absence makes recent efforts to expand the scope and deterrent effect of the prohibition highly suspect.

Simple fairness would seem to require that one know the reason for his punishment before it is imposed. The present state of insider trading jurisprudence provides no answer to that fundamental question. A reexamination of both the breadth and the impact of the prohibition would be helpful. At a minimum, proponents of the prohibition should be required to present a fully acceptable justification for the prohibition before further efforts to expand it are undertaken.