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Using Inside Information to Abstain from Trading

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Abstract

Rule 10b-5 prohibits insiders from trading on inside information. However, nothing prohibits insiders from using inside information to *abstain* from trading. Because of this "abstention problem," legal commentators -- both those opposed to insider trading and those defending it -- have argued that insiders subject to Rule 10b-5 retain an advantage over public shareholders. The paper shows that insiders prohibited from trading while in possession of inside information are not better off than public shareholders even though they can use such information to abstain from trading. In fact, insiders who could neither trade nor abstain on inside information would be systematically worse off than public shareholders. The paper also explains why such insider abstention is both economically desirable and "fair." The paper concludes by examining the implications of these insights for various issues in insider trading regulation -- including the "use vs. possession" debate and the SEC's recently drafted regulation that creates a safe harbor from Rule 10b-5 liability.

JEL Classification: G18, G38, K22

Key Words: insider trading, managers, inside information [add]

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I. Introduction

Insider trading law limits the ability of insiders – including a firm's officers and directors – to use private information to make trading profits at the expense of public investors. The traditional goals of insider trading law are to "level the playing field" between insiders and public shareholders and to preserve investor confidence in the market.[1] Some academic commentators have argued that insider trading is likely to distort managerial incentives and increase the cost of capital, and therefore that prohibiting insider trading also promotes economic efficiency.

The primary mechanism for regulating insider trading is the duty to "disclose or abstain," which arises under Rule 10b-5 of the Securities Exchange Act of 1934. Under the duty to disclose or abstain, a person in possession[2] of material nonpublic information must either disclose the information or abstain from trading when the other

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1 *See infra* Part II.A.2.

2 The SEC and the influential Second Circuit Court of Appeals take the view that a person violates Rule 10b-5 by trading while in possession of material inside information. However, some courts have ruled that a person who trades while in possession of material inside information does not violate Rule 10b-5 unless she *uses* the inside information in deciding to carry out the trade. For now, I will assume that the SEC's "possession" interpretation of Rule 10b-5 is in effect. In Part IV, I will examine the "use vs. possession" debate and explain why the SEC's "possession" interpretation is more consistent with the traditional fairness goals of insider trading law than is the "use" interpretation.

party to the transaction is entitled to know the information because of a fiduciary duty or other relationship of trust and confidence between them.[3]

However, while Rule 10b-5 prohibits trading on material inside information, it does not prohibit *abstaining* on inside information. Thus, in some cases Rule 10b-5 permits insiders to use material inside information to their advantage. For example, a manager who is considering selling stock on Tuesday might learn on Monday of good news that will be released Wednesday and is likely to boost the stock price. The manager abstains from selling on Tuesday, when the stock is trading at $10, and sells on Thursday after the good news has been announced and boosted the stock price to $12. A similarly situated outsider, not knowing of the impending good news, would sell his stock on Tuesday for $10 per share and therefore make less on the sale.

Because of this "abstention problem," legal commentators – both those in favor of insider trading regulation and those opposed to it -- have argued that insiders retain an advantage over public shareholders even if they cannot trade on inside information. For example, Henry Manne, the most prominent academic critic of insider trading regulation, has written:

> "A failure to sell cannot be a violation of the SEC's Rule 10b-5, because there has been no securities transaction.... The upshot of all this is that people can make abnormal profits in the stock market simply by knowing when not to buy and when not to sell.... And this is a form of insider trading that no one can do anything about."[4]

[3] *See infra* Part II.A.2.

[4] Manne (1985).

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Similar views are expressed by commentators more sympathetic to insider trading regulation. According to one such commentator,

> "…'insider abstention'…is indistinguishable from [insider trading] in terms of fairness and equality of market participation…Unfortunately…it is both legally and logistically difficult to regulate the use of inside information in the decision to abstain from trading."[5]

The first purpose of this paper is to show that this view of abstention, which appears to be expressed by every commentator who has addressed the issue, is simply incorrect. The paper demonstrates that insiders prohibited from trading while in possession of inside information cannot make themselves better off than public shareholders by using inside information to abstain from trading.

Consider an insider and a similarly situated public shareholder intending to sell shares. The insider can make himself better off than the similarly situated public shareholder by abstaining from selling when he learns that *good* news will shortly emerge and boost the stock price. But suppose the insider intending to sell shares learns that *bad* news will emerge shortly, reducing the stock price. In this situation, the insider is prohibited from selling his shares until the bad news is released because selling before the bad news is made public would constitute illegal trading while in possession of inside information. As a result, the insider is forced to postpone the sale

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5 Salbu (1993).

until the bad news is disclosed, and is thereby compelled to sell his shares at the lower, post-disclosure price. A similarly situated outsider, on the other hand, is not forced to postpone his sale. Not in possession of inside information, the similarly situated outsider sells his shares before the bad news is released and the price falls. Thus, the insider compelled to abstain from selling is worse off than the similarly situated outsider who is free to sell his shares before the price falls. *In short, using inside information to abstain from trading simply compensates the insider for his inability to trade while in possession of inside information indicating that such a trade would be favorable.*

In fact, without the ability to abstain on inside information the insider prevented from trading while in possession of inside information would actually be *worse off* than a similarly situated public shareholder. If the insider could not use inside information either to trade or to abstain from trading, he would be no better off than a similarly situated outsider when the inside information indicates that a contemplated trade would be unfavorable (and the insider must therefore trade), but worse off when the information indicates that such a trade would be favorable (and the insider must therefore abstain). Under such a regime the insider would systematically underperform the similarly situated public shareholder in her trading.

The paper next examines the normative implications of insiders' ability to abstain on inside information. The paper shows that the economic objections to insider trading that have been made do not apply to insider abstention; in fact, insider abstention *reduces* agency costs by better aligning the interests of corporate insiders with those of

public shareholders. Similarly, the fairness objection leveled at insider trading applies does not appear to apply to insider abstention when insiders cannot trade on inside information.

Three policy implications flow from this normative analysis. First, contrary to the arguments of both the critics and defenders of Rule 10b-5 all of the goals of insider trading regulation can be achieved simply by preventing insiders from *trading* on inside information. Insider abstention is not, as critics of Rule 10b-5 argue, a large gap in the regulatory system that makes insider trading regulation a hopeless task. Nor is there any need, as some who favor strict equality between insiders and outsiders argue, to develop a method for preventing insiders from abstaining on inside information.

Second, the analysis sheds light on the "use vs. possession" debate in insider trading law. The SEC takes the position that a person trades in violation of Rule 10b-5 if he can be shown to have been in possession of material inside information indicating that the trade was favorable. Others have argued that to establish liability the SEC must demonstrate that the person "used" the inside information in deciding whether to trade. The paper shows that the "use" standard permits insiders both to trade and abstain on inside information and thus that the "possession" standard better promotes equality between insiders and outsiders. Third, the analysis leads to a critique of the recent SEC insider trading regulation creating a "safe harbor" from Rule 10b-5 liability. The SEC's safe harbor regulation, it is shown, fails to promote equality between insiders and outsiders. The paper shows how such equality could be achieved if that is desired.

The remainder of the paper is organized as follows. Part II describes insiders' informational advantage, Rule 10b-5, and the policy arguments for the prohibition against insider trading. Part III examines the use of inside information to abstain from trading. It demonstrates that an insider who is prevented from trading on inside information but who can abstain on inside information is not better off than a similarly-situated public shareholder because the advantage provided by her ability to abstain on inside information simply offsets the disadvantage of not being able to go forward with a trade after she learns material nonpublic information suggesting that the trade would be favorable. It then shows that an insider who can neither trade nor abstain on inside information would be worse off than a similarly-situated public shareholder. Part IV considers the normative and policy implications of the analysis. Part V concludes.

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II. Insider Trading and Rule 10b-5

This Part briefly describes insiders' informational advantage and the use of Rule 10b-5 to regulate insider trading (Section A). It then explores the policy justifications for Rule 10b-5 (Section B).

A. Insiders' Informational Advantage and Rule 10b-5

1. Insiders' Informational Advantage

It is well known that corporate insiders – the officers, directors, and large shareholders of a corporation – have access to nonpublic ("inside") information bearing on the value of the corporation's stock by virtue of their positions in, or relationship with, the corporation.[6] This information might indicate that the stock price is likely to increase. For example, an insider might learn that last quarter's earnings are better than expected, that there will be an unanticipated takeover bid, or that there has been a

[6] There are other types of insiders with access to inside information, such as "temporary" insiders -- lawyers, accountants, and bankers who in the course of providing services to the firm acquire inside information about the value of the stock -- and "tippees" –those who receive information from regular or temporary insiders. Although the analysis and examples in this paper focus on corporate insiders, they generally apply to other types of insiders as well. The most important difference is that the ability of corporate insiders to trade or abstain on inside information is likely to affect the economic performance of the firm while the ability of tippees and temporary insiders to trade or abstain on inside information is unlikely to have any such effect.

significant technological breakthrough or the acquisition of an important new customer. Alternatively, the information could indicate that the stock price is likely to fall. The insider might learn of a negative earnings surprise, the failure of a key product, the cancellation of an important contract, or impending litigation against the firm that is likely to significantly reduce the firm's value.

If permitted to trade freely on this type of information, the insiders could use it to their advantage. When the information indicates that the stock is underpriced, insiders could buy the stock before the information is released and benefit from the subsequent appreciation. For example, suppose that the CEO of ABC Corp. learns that earnings will exceed expectations and that, when the information is released, the news will boost the price of the stock, now trading at $10 per share, to $12. The CEO can use this information to make a profit of $2 per share.

When information indicates that the stock is overpriced, insiders could sell the stock before the price falls. For example, suppose that the CEO of ABC Corp. learns that earnings will fall short of expectations and that, when the information is released, the price of the stock, which is now $10, is likely to drop to $8. The CEO can make a profit (by avoiding a loss) of $2 per share by selling the stock now rather than waiting until the bad news is released.

2. Rule 10b-5

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Although insiders will inevitably have an informational advantage over other shareholders, for over 60 years there has been a consensus among the public, Congress, and government regulators that insiders should not be permitted to profit freely from this advantage.

The consensus is reflected in a system designed to help level the playing field between insiders and public investors. The primary mechanism for regulating the trading of insiders is the duty to "disclose or abstain," which arises under Rule 10b-5 of the Securities Exchange Act of 1934 ("the 1934 Act").[7] Under the duty to disclose or abstain, a person in possession of material[8] nonpublic information must either disclose

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[7] Other federal rules designed to regulate trading by insiders include Rule 14e-3 under the 1934 Act (imposing a duty to disclose or abstain on a person who receives material nonpublic information about a tender offer that originates with either the offeror or the target, Section 16(b) of the 1934 Act (banning short-swing profit-taking by corporate insiders), and Section 16(c) of the 1934 Act (forbidding short-selling by corporate insiders). In addition, a variety of federal criminal statutes, such as RICO and the mail and wire fraud statutes have been invoked to enforce Rule 10b-5. *See* Donald C. Langevoort, INSIDER TRADING REGULATION 2 n. 5 (1989). There are also state corporate-law restrictions on trading by insiders. *See* Marleen A. O'Connor, *Toward a More Efficient Deterrence of Insider Trading: The Repeal of Section 16(b)*, 58 FORDHAM L. REV. 309, 339-41 (1989) (collecting cases) *and* Cal. Corp. Code 25402. However, state insider trading law has largely been supplanted by federal law. *See* Clark, CORPORATE LAW (1986) 265, 306-09.

[8] In *SEC v. Texas Gulf Sulphur Co.*, the Second Circuit held that "material" facts are those to which a "reasonable man would attach importance in determining [whether to buy or sell shares]." 401 F.2d 833, 849 (2d Cir. 1968) (citation omitted). In interpreting the term "material" under a related statute, the Supreme Court provided a similar definition. *See TSC Indus., Inc. v. Northway Inc.,* 426 U.S. 438, 449 (1976) (holding that under Rule 14e-9, the general antifraud provisions of the SEC's proxy rules, an omitted fact is material "if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote"). *See* generally Clark (1986) at § 8.10.4 & n.25. More recently, the Court has indicated that the purpose of the materiality standard is "to filter out essentially useless information that a reasonable investor would not consider significant . . . in making his investment decision." *Basic Inc. v. Levinson*, 485 U.S. 224, 234 (1988) (citation omitted).

the information or abstain from trading when the other party to the transaction is entitled to know the information because of a fiduciary duty or other similar relationship of trust and confidence between them.[9] The rule applies to corporate insiders trading in their firm's shares because they owe a fiduciary duty to public shareholders.[10]

Rule 10b-5, which was promulgated by the Securities and Exchange Commission ("SEC") in 1942, does not expressly prohibit insiders from trading on inside information. However, its prohibition against "any act, practice, or course of business which operates . . . as a fraud or deceit upon any person, in connection with the purchase or sale of any security" was interpreted by the SEC in 1961 to impose the duty to disclose or abstain. [11] According to the SEC:

> [T]he obligation [to disclose or abstain] rests on two principal elements; first, the existence of a relationship giving access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone, and second, the inherent unfairness

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9 *See Chiarella v. United States*, 445 U.S. 222, 230-31 (1980).

10 Shareholders who own enough stock to exercise control over the corporation are considered to owe fiduciary duties to public shareholders even though their legal relationship with the public is not the same as that of the corporation's employees. *See* Donald C. Langevoort, INSIDER TRADING REGULATION 72 (1989).

11 In *In re Cady, Roberts & Co.,* 40 S.E.C. 907, 911 (1961), the SEC stated:
"[I]nsiders must disclose material facts which are known to them by virtue of their position but which are not known to persons with whom they deal and which, if known, would affect their investment judgment. [If disclosure would be] improper or unrealistic [the insider must] forego the transaction."

> involved where a party takes advantage of such information knowing that it is unavailable to those with whom he is dealing.[12]

During the last 15 years, Congress has sharply increased the penalties for violating Rule 10b-5. In 1984, Congress passed the Insider Trading Sanctions Act ("ITSA"), which gave the SEC the discretion to seek civil penalties in Rule 10b-5 cases of up to three times the profit made or loss avoided (in addition to disgorgement of profits, which was the civil penalty prior to 1984), as well as increased criminal penalties (for natural persons) tenfold from $10,000 to $100,000.[13] In 1988, Congress passed the Insider Trading and Securities Fraud Act ("ITSFEA"), which increased criminal penalties (for natural persons) from $100,000 to $1 million and raised maximum prison sentences from five to ten years.[14] To facilitate enforcement of Rule 10b-5, ITSFEA also created a bounty system to encourage the reporting of illegal insider trading by others, and imposed penalties on employers and other "controlling persons" that failed to take steps to prevent illegal insider trading.[15]

Elsewhere, I explain why despite these severe penalties Rule 10b-5 might not

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12 *Id.* at 912. The duty to disclose or abstain was later adopted by the Second Circuit in *SEC v. Texas Gulf Sulphur*, 401 F.2d 833 (2d Cir. 1968), and was implicitly acknowledged by the Supreme Court in *Chiarella v. United States*, 445 U.S. 222 (1980), which conditioned the duty on the existence of a fiduciary or other special relationship between the parties.

13 Insider Trading Sanctions Act, 15 U.S.C. § 78u-1(a)(2) (1984).

14 *See* Insider Trading and Securities Fraud Enforcement Act, 15 U.S.C. § 78ff(a) (1988).

15 *See* Marleen A. O'Connor, *Toward a More Efficient Deterrence of Insider Trading: The Repeal of Section 16(b)*, 58 FORDHAM L. REV. 309, 336-337 (1989).

always deter insiders from trading on material inside information and how Rule 10b-5 enables insiders to make some profits legally trading on important but "sub-material" inside information.[16] However, to focus on the effects and desirability of insiders' using inside information to abstain from trading, I will assume for present purposes that Rule 10b-5 effectively prevents insiders from trading while in possession of inside information.

B. Policy Arguments for Rule 10b-5

Although there is a consensus among the public, Congress and the SEC about the undesirability of insider trading, academics have long debated this issue. Below, I describe the main policy arguments that have been offered against insider trading and in support of Rule 10b-5. The purpose of this Section is not to endorse these arguments, but simply to summarize them.[17] This summary will lay the groundwork for showing in Part V that the arguments raised against insider trading do not apply to insider abstention when the insiders are subject to Rule 10b-5. Indeed, Part V will show that insider abstention is both fair and economically efficient. Thus, even those who believe insider trading is undesirable should view as desirable insiders' using inside information to abstain from trading.

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16 *See* Fried (1998).

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1. Distortion of Managerial Incentives

Opponents of insider trading argue that insider trading can adversely affect managers' incentives and thereby hurt corporate performance and shareholders. There are a number of potential distortions arising from insider trading. First, the prospect of insider trading profits may induce managers to engage in overly risky projects in order to generate large price swings. The larger the price swing, the greater the opportunity to profit from inside information (e.g., buy stock at a low price before releasing good news indicating that the stock is worth much more). To be sure, the price swing could be negative. However, managers can avoid the cost associated with a large negative price swing by selling before the bad news is released.[18] Second, the ability to engage in insider trading might discourage managerial effort by enabling managers to profit even when they generate bad news.[19] Third, insider trading could interfere with internal

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17 For my own views, *see* Fried (1998), at 313-316.

18 *See, e.g.*, Frank Easterbrook, *Insider Trading, Secret Agents, Evidentiary Privileges, and the Production of Information*, 1981 SUP. CT. L. REV. 309, 332 (the prospect of insider trading profits may encourage managers to engage in overly risky projects). *See also* Mark Bagnoli & Naveen Khanna, *Insider Trading in Financial Signaling Models*, 47 J. FIN. 1905 (1992) (management may have an incentive to act inefficiently to make insider trading profits); Roy A. Schotland, *Unsafe at any Price: A Reply to Manne, Insider Trading and the Stock Market*, 53 VA. L. REV. 1425, 1448-89 (managers permitted to trade on inside information will run company to maximize insider trading opportunities rather than to maximize shareholder value). [add Bebchuk studies]

19 *See, e.g.*, James D. Cox, *Insider Trading and Contracting: A Critical Response to the "Chicago School,"* 1986 DUKE L.J. 628 (the ability to trade on inside information may discourage

firm communications by giving managers an incentive to hoard and trade on inside information before revealing it to others.[20] Fourth, insider trading could give managers an incentive to postpone disclosure of information to the market. Indeed, managers might have an incentive to disseminate rumors in order to create price fluctuations on which they can profit.[21]

2. Increase in Cost of Capital

Opponents of insider trading also argue that even if insider trading does not adversely affect managerial incentives, it increases the cost of equity capital.[22] Insider trading profits reduce--dollar-for-dollar--the profits of other stockholders. [23] To the

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managerial effort by permitting managers to profit even when news is bad); Saul Levmore, *Securities and Secrets: Insider Trading and the Law of Contracts*, 68 VA. L. REV. 117, 149 (1982) (same); Morris Mendelson, *The Economics of Insider Trading Reconsidered*, 117 U. PA. L. REV. 470, 489-90 (1969) (reviewing Henry G. Manne, INSIDER TRADING AND THE STOCK MARKET (1966)) (same).

[20] *See, e.g.*, Robert J. Haft, *The Effect of Insider Trading Rules on the Internal Efficiency of the Large Corporation*, 80 MICH. L. REV. 1051, 1064 (1982) (the ability to trade on inside information could interfere with internal firm communications).

[21] *See* Bainbridge (1986); Dyer (1992).

[22] *See* Lawrence M. Asubel, *Insider Trading in a Rational Expectations Economy*, 80 AM. ECON. REV. 1022, 1023 (1990) (insider trading can inefficiently increase the cost of capital); Victor Brudney, *Insiders, Outsiders, and Informational Advantages Under the Federal Securities Laws*, 93 HARV. L. REV. 322, 489 (1979) (same).

[23] *See* H. Nejat Seyhun, *Insiders' Profits, Costs of Trading, and Market Efficiency*, 16 J. FIN. ECON. 189, 190 (1986). Insider trading profits reduce the profits earned by other investors both directly and indirectly. Insider trading profits reduce other investors' profits directly to the

extent that there is insider trading, investors will anticipate lower returns from investing in stock and therefore be willing to pay less for it. Insider trading can also reduce the supply of equity capital by undermining public confidence in the stock market.[24]

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extent that market makers match investors' orders with those of corporate insiders trading on inside information (so that the market makers' net position is unaffected). If an investor sells to a corporate insider buying on favorable inside information, he or she is deprived of the gain that will occur when that information is released. If an investor buys from an insider selling on negative inside information, the loss is transferred from the insider to the investor. *See* William K.S. Wang & Marc I. Steinberg, INSIDER TRADING 62-64 (1996).

Insider trading profits reduce other investors' profits indirectly to the extent that corporate insiders trade with market makers in a manner that leaves the net position of public investors unchanged. Although the market makers will, in the first instance, bear the cost of such trading, this cost forces them to increase their bid-ask spread to ensure that the extra profit that the market makers make trading with noninsiders compensates the market makers for the loss that they will suffer when they trade with insiders using inside information. *See* Seyhun, *supra*, at 191. The increase in the bid-ask spread imposes additional transaction costs on all of those buying and selling stock, indirectly reducing public investors' profits.

It should be emphasized that insider-trading profits reduce the profits of other investors dollar-for-dollar only if insider trading has no economic effect other than to redistribute returns among the corporation's shareholders. To the extent that insider trading adversely affects a corporation's performance, every dollar of profits made by corporate insiders trading on inside information reduces the profits made by all investors (including insiders) by an even greater amount. [discuss possibility of compensation offset, including Roulstone]

[24] As Arthur Levitt, Jr., the former chairman of the American Stock Exchange, observed: "If the investor thinks he's not getting a fair shake, he's not going to invest, and that is going to hurt capital investment in the long run." *The Epidemic of Insider Trading*, Bus. Wk., Apr. 29, 1985, at 79. *See also* Committee on Federal Regulation of Securities, *Report of the Task Force on Regulation of Insider Trading: Part I: Regulation Under the Antifraud Provisions of the Securities Exchange Act of 1934,* 41 BUS. LAW. 223, 227 (1985) [hereinafter Task Force Report, Part I] ("[P]eople will not entrust their resources to a marketplace they don't believe is fair, any more than a card player will put his chips on the table in a poker game that may be fixed."). The fact that a number of emerging markets have been forced to take steps to reduce insider trading in order to attract investors provides anecdotal evidence in support of this view. *See, e.g.*, Vincent Boland, *Capital Markets Reforms Promised*, FIN. TIMES, May 14, 1997, at 6 (reporting that the Czech government, in response to pressure from investors, plans to set up an agency to regulate the stock market and crack down on insider trading).

3. Fairness

Finally, many commentators share the intuition that--regardless of the economic consequences--it is simply unfair for those with inside information to trade with those who cannot obtain such information.[25]

[To be added]

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[25] *See, e.g.*, Task Force Report, Part I, *supra* note, at 227-28 (concluding that the "fair play" basis for the regulation of trading by corporate insiders is still sound). *See* generally Victor Brudney, *Insiders, Outsiders, and Informational Advantages Under the Federal Securities Laws*, 93 HARV. L. REV. 322 (1979); Kim Lane Scheppelle, *It's Just Not Right: The Ethics of Insider Trading*, 56 LAW & CONTEMP. PROBS. 123 (1993); Alan Strudler and Eric W. Orts, *Moral Principle in the Law of Insider Trading*, 78 TEX. L. REV. 375 (1999).

III. *Abstaining* on Inside Information

Section A describes the conventional wisdom about insider abstention: that insiders who cannot trade on inside information nevertheless have an advantage over public shareholders because they can use inside information to abstain from trading. Section B explains why the ability of such insiders to use inside information to abstain from trading does not make them better off than public shareholders. Section C considers the case in which insiders can neither trade nor abstain on inside information. These insiders, it is shown, are systematically worse off than public shareholders.

A. Abstaining on Inside Information: The Conventional Wisdom

Rule 10b-5 prohibits trading on material inside information. However, commentators on both sides of the insider trading debate have long argued that insiders still have an advantage over public shareholders because they can use inside information to abstain from trading.

For example, suppose that the CEO of ABC Corp. intends to sell 1 million shares next Tuesday. The market price is currently $10 per share. On Monday, the day before the planned sale of the stock, the CEO learns that last quarter's earnings are substantially higher than expected. The earnings announcement, which is to be released on Thursday, is likely to cause the market price to increase significantly. The

CEO abstains from selling until the earnings are released. The earnings are released on Thursday, boosting the stock price to $12. The CEO then sells his 1 million shares for $12 each on Friday, for a total of $12 million. Compare the CEO to a similarly situated public shareholder who is also intending to sell 1 million shares for $10 on Tuesday but does not have the same inside information. Unaware that the stock price is likely to increase at the end of the week, the public shareholder does not delay his trade. He sells his shares for $10 each on Tuesday, for a total of $10 million. Inside information thus enables the CEO to make an extra $2 million selling his stock. However, the CEO does not violate Rule 10b-5. There is no violation because the CEO does not *trade* on inside information. He *abstains* on inside information, and trades only once the information has been released and is public. Not surprisingly, there is evidence insiders use inside information in this very manner.[26]

Because of this "abstention problem," legal commentators – both those in favor of insider trading regulation and those opposed to it -- have argued that insiders retain an advantage over public shareholders even if they cannot trade on inside information.

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[26] *See, e.g.,* Asjeet Lamba and Walayet Kahn, *Exchange Listings and Delistings: The Role of Insider Information and Insider Trading,* 22 JOURNAL OF FINANCIAL RESEARCH 131-146 (1999) ("We find evidence consistent with the notion that insiders act on their private information of an impending exchange listing by purchasing, or postponing the sale of, stock on private account."); Ji-Chai Lin and John Howe, *Insider Trading in the OTC Market,* 45 JOURNAL OF FINANCE 1278 (1999) ("Seyhun (1986) suggests insiders can profit by refraining from purchasing stock until after the release of unfavorable information and by refraining from selling stock until after favorable information is released. Our results support this proposition.") [elaborate these results in text].

For example, Henry Manne, perhaps the most well-known academic critic of insider trading regulation has written:

> "A failure to sell cannot be a violation of the SEC's Rule 10b-5, because there has been no securities transaction…. The upshot of all this is that people can make abnormal profits in the stock market simply by knowing when not to buy and when not to sell…. And this is a form of insider trading that no one can do anything about."[27]

Manne has also written:

> "After all, it is very difficult to prove that a person benefited from undisclosed information when all he did was raise his reservation price and *not sell* at the old price. Yet it now seems apparent that this form of insider "trading" may be more common than the type in which a person seeks to *buy* shares. The economic effect, in any event, is the same."[28]

Likewise, Judge Posner has said:

> "The costs of enforcing the rule against insider trading are high. Not only are concepts like insider and inside information slippery but devices for evasion of the rule abound . . . There is the problem that one can benefit from inside information by not making a trade that one would have made (to the benefit one's trading partner) if one hadn't had the information."[29]

Similar views have been expressed by commentators who are more sympathetic to insider trading regulation. According to Steve Salbu,

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[27] Henry Manne, *Insider Trading and Property Rights in New Information,* 4 CATO J. at 938 (1985).

[28] Henry Manne, *Economic Aspects of Required Disclosure Under Federal Securities Law*, in WALL STREET IN TRANSITION, at 78 (1974).

[29] Richard Posner, *Insider Trading and the Problem of Entrepreneurial Reward,* ECONOMIC

"…'insider abstention'…is indistinguishable from [insider trading' in terms of fairness and equality of market participation…Unfortunately…it is both legally and logistically difficult to regulate the use of inside information in the decision to abstain from trading."[30]

ANALYSIS OF LAW (4th Ed. 1999), Section 14.9, 417-418.

[30] Salbu (1993). *See also* Saul Levmore, *Securities and Secrets: Insider Trading and the Law of Contracts,* 68 VA. L. REV. 117, 119 (1982) ("Closer examination of the disclose-or-abstain scheme, for example, suggests that requiring outsiders to take investment risks blindly -- while knowledgeable insiders avoid these risk by abstention -- may be as unfair as allowing insiders to trade as they wish. Thus, in many cases the disclose-or-abstain pattern scarcely does justice to the fairness goal."). *See also* Boyd Kimball Dyer, *Economic Analysis, Insider Trading and Game Markets*, UTAH LAW REVIEW (1992), at 23-24. ("Prohibiting insider trading reduces these six conflicts of interest, but the prohibition does not prevent an insider from obtaining an advantage from inside information from 'not trading.' For example, an insider who is about to sell for independent reasons might 'not sell' because of favorable inside information, or, being about to buy, "not buy" because of unfavorable inside information."); Kraakman (1991); Saikrishna Prakash, *Our Dysfunctional Insider Trading Regime,* 99 COLUMBIA LAW REVIEW 1491, fn. 53 (1999). ("Even trading abstention results in some advantages to the insider, because the trader presumably knows not to dispose shares when advantageous information is about to be made public. Likewise the insider will not purchase shares when the company's future appears more thorny than rosy. Neither of these insider abstention strategies results in any liability. Nevertheless, the insider is using her informational superiority to her advantage.")

Some German commentators have argued that German insider trading law, which is drafted differently than Rule 10b-5, prohibits insider abstention. Hartmut Krause, *The German Securities Trading Act (1994): A Ban on Insider Trading and an Issuer's Affirmation Duty to Disclose Material Nonpublic Information,* INTERNATIONAL LAWYER (1996). ("Some commentators take the view that the German Act outlaws every exploitation of inside information, not just in connection with a purchase or sale. They argue that the obligation also extends to insiders who, with full knowledge of the facts, abstain from transactions they would have carried out had they not possessed inside information. Apart from doubts as to whether identification of such a situation will ever be practicable, this argument is not very convincing. The criminal nature of an insider violation calls for a strict construction of the statutory language. The wording mentions only two actions: purchase and sale. The language provides no basis for applying the criminal law concept that holds a perpetrator liable for passivity in the face of a duty to act. This rule might apply when criminal liability attaches to a certain result, such as the victim being dead or injured or assets being destroyed or damaged. However, the liability of insider traders attaches to an action. The wording does not mention or refer to an element such as a profit from the transaction. Hence, there should be no grounds to punish loss-avoiding insider abstention.").

B. The Effect of Insider Abstention

As this Section shows, insider abstention does not make insiders better off than similarly situated public shareholders as long as insiders cannot trade on inside information.

The reason is as follows. Although the example in Section A makes clear that an insider can make himself better off than a similarly situated public shareholder by abstaining on inside information, it focuses our attention on only half the picture: the situation in which the insider learns, before selling, that *good* news will emerge shortly, boosting the stock price. Consider the other half of the picture: the situation in which the insider learns, before selling, that *bad* news will emerge shortly, reducing the stock price. In this situation, the insider is prohibited from selling his shares because doing so would constitute trading while in possession of inside information. As a result, the insider is forced to postpone the sale until the bad news is disclosed, and he sells his shares at the lower, post-disclosure price. A similarly situated outsider, on the other hand, is not forced to postpone his sale. With no access to inside information, he can sell his shares before the bad news is released and the price falls. Thus, when he learns bad news the selling insider is worse off than the similarly situated public shareholder who is free to sell his shares before the price falls.

For example, suppose that the CEO of ABC Corp. intends to sell 1 million shares next Tuesday. The market price is currently $10 per share. On Monday, the day before the planned sale of the stock, the CEO learns that last quarter's earnings are substantially *lower* than expected. The earnings announcement, which is to be released on Thursday, is likely to cause the market price to fall significantly. The CEO cannot sell his shares on Tuesday while in possession of inside information indicating that the stock price will fall. He therefore is forced to abstain from selling until the earnings are released. The earnings are released on Thursday, reducing the stock price to $8. The CEO then sells his 1 million shares for $8 each on Friday, for a total of $8 million. Compare the CEO to a similarly situated public shareholder who is also intending to sell 1 million shares for $10 on Tuesday but does not have the same inside information. Lacking any reason to do so, the public shareholder does not delay his trade. He sells his shares for $10 each on Tuesday, for a total of $10 million. Thus having inside information costs the CEO $2 million in selling his stock. In short, the insider's advantage from abstaining on inside information is offset by the insider's disadvantage from his inability to trade when he has inside information indicating that the trade would benefit him.

C. Insiders Who Can Neither Trade Nor Abstain on Inside Information

Having seen that insiders prevented from trading on inside information are not better off than similarly situated shareholders because of their ability to abstain on inside information, let us consider the situation of insiders who, hypothetically, are subject to a regime that prevents them from both trading and from abstaining on inside information.

Returning to the earlier example, suppose that the CEO of ABC Corp. intends to sell 1 million shares next Tuesday. The market price is currently $10 per share. On Monday, the day before the planned sale of the stock, the CEO learns that last quarter's earnings are substantially higher than expected. The earnings announcement, which is to be released on Thursday, is likely to cause the market price to increase to $12. The CEO would like to abstain from selling until the earnings are released. However, under a no-trade/no-abstention regime, the CEO would be required to sell his shares on Tuesday, as he had intended before learning the good news. He thus makes $10 million selling his shares, the same as the similarly situated outsider intending to sell her shares on Tuesday.

Now suppose instead that the CEO learns that last quarter's earnings are substantially lower than expected. The earnings announcement, which is to be released on Thursday, is likely to cause the stock market price to drop from $10 to $8 per share. The CEO would like to sell on Tuesday before the earnings are released in order to get $2 more per share for his stock. However, under a rule that prohibits trading while in possession of insider information, the CEO would be required to abstain from trading

until the news emerges on Thursday. The CEO thus sells his shares on Friday for $8 per share. He thus makes $8 million per share, less than the similarly situated outsider who sells her shares for $10 million on Tuesday.

In short, the insider intending to sell is worse off than a similarly situated public shareholder when she learns bad news, and no better off than a similarly situated public shareholder when she learns good news. Thus, on average the insider intending to sell shares is worse off than a similarly situated public shareholder under a regime in which she can neither trade nor abstain on inside information.[31]

IV. Normative and Policy Implications

This Part examines the normative and policy implications of insiders' use of inside information to abstain from trading in light of the analysis in Part III. Section A argues that to Rule 10b-5 abstaining on inside information by corporate insiders subject to Rule 10b-5 is both efficient and fair. Section B considers three policy implications of the paper's analysis. The first is that insider abstention does not represent a "loophole" in the regulatory system. There is no need, as some critics of insider trading have argued, to try to prevent insiders from using inside information to abstain from trading in order to level the playing field between insiders and public investors. Indeed, such

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31 It is easy to see that the analysis is symmetric for an insider intending to purchase

steps would likely create inefficiencies and put insiders in a worse position than public shareholders. Nor, as critics of insider trading regulation have argued, does insider abstention make achieving equality between insiders and outsiders a hopeless endeavor. Second, to the extent parity is the goal of insider trading regulation, the SEC's "possession" interpretation of Rule 10b-5 -- that an insider should be considered to violate Rule 10b-5 if she trades while in possession of inside information, even if the SEC cannot prove that she "used" the information in deciding to trade – should be favored over the "use" interpretation. Under the latter interpretation, insiders' advantage from using inside information to abstain from trading will not be offset by the burden of being prevented from trading when they have inside information indicating that the trade will be favorable. Third, the SEC's recently enacted safe harbor from Rule 10b-5 liability, by sometimes enabling insiders to both trade and abstain while in possession of inside information, fails to promote equality between insiders and outsiders. The paper shows that the regulation could be modified to achieve such parity.

A. The Desirability of Using Inside Information to Abstain from Trading

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shares.

At least some commentators who believe that trading on inside information is undesirable believe that using inside information to abstain from trading is also undesirable.[32] This Section shows that the efficiency and fairness arguments made by those critical of insider trading do not apply to abstaining on inside information, and that therefore even those opposed to insider trading on economic or fairness grounds should have no objection to insider abstention. Indeed, abstention can improve managers' incentives.

1. Managerial Incentives

As we saw in Part II.B.1, those opposed to insider trading argue that insider trading distorts managerial incentives by (1) inducing managers to engage in overly risk projects so as to generate large price swings, (2) discouraging effort by enabling managers to profit even when they generate bad news; and (3) giving managers an incentive not to share information internally within the firm; and (4) giving managers an incentive to delay disclosure of news to the market or to generate rumors.

However, each of these distortions arises only because the manager is able to buy or sell the stock at a price that does not reflect the actual value of the stock, and thereby profit (or avoid a loss) when the inside information bearing on the value of the stock

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[32] *See* Salbu.

emerges. For example, managers will have an incentive to engage in overly risky projects only if, prior to the announcement of the good results of the project, the managers can buy stock at a price that is lower than that which will prevail when the good news is released. Similarly, managers who know good news have an incentive to delay disclosure of the news to the market if they can buy stock at a price that does not reflect the good news before the good news is released.

Insiders who abstain on inside information -- that is, postpone their trading until the inside information is released-trade at a price that reflects the inside information. Because they sell or buy stock at its "correct" (full-information) value, their effort and project-choice incentives are not in any way distorted. And because insiders abstaining on inside information benefit from the release of the information -- whether it is good or bad -- they have no incentive to hoard information within the firm or to delay disclosure to the market.

In fact, the ability to trade to abstain and trade at a more accurate price reduces agency costs by better aligning managers' interests with those of shareholders. For example, suppose under a CEO's direction the firm unexpectedly increases its earnings. The CEO was intending to sell on Tuesday, but on Monday learns that the good news will emerge on Wednesday, boosting the stock price. We would want the CEO to be able to sell at the higher price after Wednesday in order to increase his incentive to generate good news. The more value the managers create, the higher they can sell their shares for. Abstention thus aligns managers' incentives properly.

2. Cost of Capital

As we saw in Part II.B.2, those opposed to insider trading argue that it increases the cost of capital by reducing public shareholders' returns. Abstaining on inside information also reduces public shareholders' returns, by enabling the insider to avoid an unfavorable trade that would otherwise transfer value to public shareholders. However, an insider subject to Rule 10b-5 will not be able to engage in a favorable trade that would otherwise transfer value from public shareholders. This increases public shareholder's returns. Thus, public shareholders' returns are, on balance, unaffected when an insider unable to trade on inside information uses inside information to abstain from trading.

To be sure, preventing insiders from abstaining on inside information would increase public shareholders' returns even more. But to my knowledge, those who argue that corporate insider trading undesirably increases the cost of capital do not argue that the returns of public shareholders should be subsidized by forcing corporate insiders to engage in trades from which they would prefer to abstain.

And if taxing corporate insiders to increase the returns of public shareholders were considered desirable, there would be much easier ways of implementing it than through a prohibition on insider abstention. First, as other commentators have noted, a prohibition on insider abstention is a prohibition that would be difficult, if not

impossible to enforce in most cases. A much easier way to tax corporate insiders would be to require that insiders contribute x% of the value of each trade (which is easily determinable) to the corporation.

Second, corporate insiders could always escape an "abstention-prohibition tax" by never engaging in insider abstention. For example, they could instruct a trustee sell or buy their shares according to a predetermined schedule, and not cancel the arrangement while in the possession of inside information suggesting that the cancellation would be favorable to them.

3. Fairness

[To be added]

B. Policy Implications

1. The Potential Effectiveness of Insider Trading Regulation

The analysis offered in Part III has some implications for insider trading regulation generally. In particular, the failure of Rule 10b-5 to prevent insiders from using inside information to abstain from trading should not be seen as an undesirable "loophole" that needs to be closed or as an embarrassing gap that makes insider trading regulation futile.

Those critical of insider trading regulation, such as Henry Manne, have used insider abstention to argue that insider trading is hopeless. The analysis offered in Part III, however, shows that one can obtain parity between insiders and outsiders imply by preventing insiders from trading while in possession of inside information.[33] Commentators hostile to insider trading have considered various ways in which insiders might be prevented from abstaining based on inside information.[34] As we have seen, however, the ability of insiders to use inside information to abstain should be seen as desirable. Thus, there is no need to figure out a way to prevent insiders from using inside information to abstain from trading.[35]

2. The "Use vs. Possession" Debate in Insider Trading Law

The analysis offered can shed a great deal of light on the "use vs. possession" debate in insider trading law, a debate which has recently occupied the attention of the SEC, a number of federal appellate courts, and many commentators. [36]

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33 This is easier said than done. *See* Fried (1998); Pretrading disclosure might work. Other possibilities are discussed in Fried (1998).

34 *See e.g.,* Salbu, *supra* note __, at 340-342 (suggesting various ways of proving "fraudulent abstention")].

35 *See* Salbu, German commentators

36 *See, e.g.,* David W. Jolly, *Knowing Possession vs. Actual Use: Dual Process and Social Costs in Civil Insider Trading Transactions*, 8 GEO. MASON L. REV. 233 (1999); Karen Schoen, *Insider*

The debate is over the mental state needed to trigger a violation of Rule 10b-5. Is it sufficient to possess material information indicating the trade will be favorable even if the trade would have occurred absent this information? Or must the insider make deliberate use of the information in deciding to make the trade? Suppose, for example, that the CEO of ABC Corporation decides on Monday, when the stock is trading at $10, to sell 1000 shares of his firm's stock on Wednesday. On Tuesday, the CEO learns that earnings will be much worse than expected and that this information, which is expected to emerge on Friday, is likely to depress the stock price to $8. On Wednesday, the CEO sells 1000 shares of his stock at $10 each. On Friday, the bad news emerges, and the stock price plunges to $8. Has the CEO violated Rule 10b-5?

According to the SEC and the 2nd Circuit,[37] mere possession of inside information while trading is sufficient to violate Rule 10b-5.[38] According to the 9th and 11th Circuits,[39] mere possession by itself is not sufficient to violate Rule 10b-5. The SEC

Trading: The "Possession vs. Use" Debate, 148 U. PENN. L. REV. 239 (1999); Lacey S. Calhoun, *Moving Toward a Clearer Definition of Insider Trading: Why Adoption of the Possession Standard Protects Investors*, 32 UNIV. MICH. J. LAW REFORM 1119 (1999); Stuart Sinai, *Rumors, Possession v. Use, Fiduciary Duty and Other Current Insider Trading Considerations*, 55 BUS. LAW. 743 (2000); Allan Horwich, *Possession Versus Use: Is there a Causation Element in the Prohibition on Insider Trading*? 52 BUS. LAW. 1235 (1997).

37 *See* United States v. Teicher, 987 F.2d 112, 120 (2nd Cir. 1993).

38 An example of an insider trading statute that specifically adopts the "possession" standard is California's, which defines insider trading specifically as buying or selling a security at a time when the insider knows material inside information. *See* California Corporations Code 25402.

39 *See* United States v. Adler, 137 F.3d 1325 (11th Cir. 1998); United States v. Smith, 155 F.3d 1325 (9th Cir 1998).

must show that the insider used the information, although the courts have concluded, proof of possession gives rise to a strong inference of use.[40]

Participants in the debate have advanced a number of policy arguments in favor of each approach.[41] In defense of the possession standard, the SEC and others have argued that "use" is extremely difficult to prove.[42] Moreover, it is ambiguous – to what extent must the inside information motivate the decision to trade for it to constitute "use" – and how would that percentage be measured in any event? Finally, some have argued that one cannot be in possession of information and not use it to some extent.[43] Thus possession is equivalent to use. Proponents of the "use" standard argue that the "possession" standard is unfair because it penalizes traders who might lack intent to defraud.[44]

As we have seen, insiders' use of inside information to abstain from trading, merely compensates them for their inability to effect intended trades when they learn of inside information. If they can trade while in possession of inside information and use inside information to abstain from trading, they will then have an advantage over

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40 *See* Adler, at 1340.

41 Participants in the debate have also advanced doctrinal arguments in favor of each approach, which I will not repeat here. For summaries, *see* Horwich, Jolly, Calhoun, and Schoen.

42 *See* Schoen, supra, at 279-280.

43 *See* Teicher, at 120; Schoen, supra, at 281-2.

44 *See* Jolly, *supra* note x, at 249-250.

public shareholders. Thus to the extent lawmakers and regulators wish to achieve parity between insiders and outsiders they should implement the possession standard.

3. SEC Rule 10b5-1

As indicated in Part IV.B.2, the SEC takes the position that Rule 10b-5 does not require proof that the insider actually used the material nonpublic information in the trading position. Instead, mere proof that the insider had "knowing possession" (or "awareness") is sufficient to establish liability. In 2000, this position was formally codified by the SEC in Rule 10b5-1.

Rule 10b5-1(a) sets out the general rule against insider trading under Section 10(b) of the 1934 Securities Exchange Act and Rule 10b-5:

> "the purchase or sale of a security… on the basis of material nonpublic information…. in breach of a duty of trust or confidence that is owed … to the issuer of that security or the shareholders of that issuer, or any person who is the source of the material nonpublic information."

Rule 10b5-1(b) defines "on the basis of"

> "…a purchase or sale of a security of an issuer is 'on the basis of' material nonpublic information about that security or issuer if the person making the purchase or sale was aware of the material nonpublic information when the person made the purchase or sale."

We saw in Part III that to the extent that insiders cannot profit by trading while in the possession of inside information, their ability to abstain on inside information

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does not make them better off than public shareholders. Thus Rule 10b5-1(a) and (b) work to promote equality between insiders and outsiders.

However, Rule10b-1(c)(1) provides an "affirmative defense" to liability that, as it is currently interpreted by the SEC, tends to undermine equality between insiders and outsiders.[45] In particular, Rule 10b5-1(c)(1) indicates that

> "a person's purchase or sale is not 'on the basis of' material public information if the person making the purchase or sale demonstrates that:
>
> (A) before becoming aware of the information, the person had:
> (1) Entered into a binding contract to purchase or sell the security,
> (2) Instructed another person to purchase or sell the security for the instructing person's account, or
> (3) Adopted a written plan for trading securities;
>
> (B) The contract, instruction, or plan….
> (1) Specified the amount of securities to be purchased or sold and the price at which and the date on which the securities were to be purchased or sold;
> (2) Included a written formula or algorithm, or computer program, for determining the amount of securities to be purchased or sold and the price at which and the date on which the securities were to purchased or sold; or
> (3) Did not permit the person to exercise any subsequent influence over how, when, or whether to effect purchases or sales; provided, in addition, that any other person who, pursuant to the contract, instruction, instruction or plan, did not exercise such influence must not have been aware of the material nonpublic information when doing so; …

In short, Rule 10b5-1(c)(1) allows insiders to purchase or sell while aware of material nonpublic information as long as they are "locked in" to the trade before they become aware of that information.

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[45] Rule 10b5-1(c) actually provides two affirmative defenses, but the second is available only to entities that have created policies and procedures to ensure that those executing trades are not aware of any material public inside information bearing on the trade. Rule 10b5-1(c)(2).

If the insiders were truly locked in to the trade, then this affirmative defense to insider trading liability would not provide insiders with any advantage. While an insider's stock might be sold pursuant to a pre-arranged plan or agreement while he is aware of bad news, that same pre-arranged plan or agreement would also force the insider to sell when he is aware of good news. In other words, the insider would be permitted to trade while aware of bad news, but could not abstain while aware of good news. The insiders' trades would therefore look exactly like the trades of a similarly situated public shareholder unaware that there was any material nonpublic information bearing on the value of the shares.

Note that the situation of the insider subject to a pre-arranged plan is the exact opposite of the situation in which the insider has discretion to trade or abstain. When the insider otherwise has discretion over his trading, Rule 10b-5 prohibits an insider aware of bad news from selling, but permits an insider aware of good news to abstain from selling. But in both the case in which the insider has discretion and the case in which he is locked-in the insider is no better off than the public shareholder.

However, in June 2001, the SEC Division of Corporate Finance issued an "interpretation" of the operation of Rule 10b5-1(c) that partially undoes the equality-promoting effect of Rule 10b5-1 by giving insiders an advantage over public shareholders. In particular, the SEC indicated that terminating a trading plan while in possession of inside information does not necessarily result in a loss of the affirmative defense for past transactions, unless the plan termination reflects the fact that the

person was not acting in good faith at the time he entered the plan.[46] As a result, lawyers are suggesting that it is advisable to expressly state in the plan that the insider reserves the right to terminate the plan at any time (so that any termination will be seen as consistent with the insider's intent when he set up the plan).[47]

The problem with this interpretation is that it enables insiders to trade (through their pre-arranged plans) while aware of material nonpublic information indicating that the trade is favorable but then to cancel the plan (and thereby abstain from trading) when they become aware of information indicating that the trade would not be favorable. That is, this interpretation enables insiders to both trade and abstain on inside information, which as we saw in Part III gives insiders an advantage over public shareholders.

To be sure, there is probably a limit to an insider's ability to abstain on inside information within the safe harbor provided by Rule 10b5-1(c). Presumably, an insider could not pre-arrange and cancel planned trades more than a few times before the SEC would infer that these pre-arranged trades are not made in good faith. As a practical matter, the advantage that this interpretation gives insiders might not be significant.

However, there seems to be little cost to requiring that insiders wishing to avail themselves of the Rule 10b5-1(c) affirmative defense wait until they are unaware of

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[46] *See* Q&A 15 under the heading "Rule 10b5-1(c)" at the SEC's website www.sec.gov.

[47] *See* Ronald A. Mueller, *SEC Issues Additional Guidance on 10b5-1 Trading Plans*, 15 INSIGHTS 24 (2001).

material nonpublic information (indicating that the abstention would be beneficial to them) before canceling their plans. Insiders sell twice as many shares as they buy (in large part because they are compensated through stock options that provide them a constant flow of shares). Most plans would involve selling small amounts of shares on a regular basis. Accordingly, there would be no liquidity or diversification costs to preventing insiders from selling their shares for the period of time in which they have information indicating the stock is worth more than its market price. If the cost of imposing such a waiting requirement is indeed low,[48] and it is considered desirable to level the playing field between insiders and outsiders, such a waiting requirement should be adopted.

VI. Conclusion

[to be added.]

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[48] As discussed in Part IV.A., abstention may well provide efficiency benefits by better aligning the interests of managers and shareholders. In particular, enabling insiders to abstain from selling on good news and buying on bad news allows them to profit fully from the value that they create for shareholders, increasing their incentive to generate such value. The reduction in these benefits would need to be taken into account in determining whether it would be desirable to reverse the SEC's interpretation of Rule 10b5-1(c)'s affirmative defense.