Using Inside Information
to Abstain from Trading

by

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Abstract

Rule 10b-5 of the Securities Exchange Act of 1934, the primary instrument for regulating insider trading, prohibits insiders from trading on material inside information. However, Rule 10b-5 does not prohibit insiders from using inside information to abstain from trading. For example, a CEO who learns that good news will emerge shortly is permitted to postpone an intended sale until after the good news has emerged and boosted the stock price. Because of this “abstention problem,” legal commentators – both those opposed to Rule 10b-5 and those favoring it – have concluded that even when insiders are prevented from trading on inside information, they still retain an unerodable advantage over public shareholders. This paper shows that, contrary to the received wisdom, insiders who are prevented from trading while in possession of inside information cannot outperform public shareholders in their trading even if they are free to use such information to abstain from trading. In fact, insiders who could neither trade nor abstain while in possession of inside information would be systematically worse off than public shareholders. After examining the distributional effects of insider abstention, the paper considers the efficiency effects of insider abstention – namely, its effect on managerial incentives and the cost of capital. The paper explains that while insider trading has the potential to distort managerial incentives and increase the cost of capital, insider abstention does not. The paper concludes by examining the implications of the analysis for various issues in insider trading regulation -- including the long-standing “use vs. possession” debate under Rule 10b-5 and Rule 10b5-1(c), the SEC regulation that provides a safe harbor from Rule 10b-5 liability.

JEL Classification: G18, G38, K22

Key Words: inside information, insider trading, insider trading regulation
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I. Introduction

The issue of insider trading regulation continues to attract a considerable amount of attention from economists, legal academics, the media, stock exchanges, and government agencies around the world. Although academics continue to debate the economic desirability of insider trading, the consensus among the U.S. public, Congress, and the Securities and Exchange Commission (SEC) is that such insider trading is “unfair” and erodes investor confidence in the market. This consensus has given rise to a set of insider trading laws that attempts to preserve investor confidence in the market and “level the playing field” between corporate insiders and public shareholders.

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 (“the 1934 Act”). Under the duty to disclose or abstain, a person in possession of material nonpublic information must either disclose 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 relationship of trust and confidence between them. For example, because a firm’s managers are considered to owe a fiduciary duty to the firm’s shareholders, they are prohibited from trading in the firm’s stock when in possession of material inside information.

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1 See, e.g., Utpal Bhattacharya and Hazem Daouk, The World Price of Insider Trading, 57 J. Fin. 75 (2002).
4 See infra Part II.B.
5 See infra Part II.B.
6 The SEC has ruled that an insider subject to Rule 10b-5 violates the rule by trading while “in knowing possession” (i.e., aware) of material inside information. The influential Second Circuit Court of Appeals also takes this view. However, other courts have held that an insider who trades while in possession of material inside information does not violate Rule 10b-5 unless she uses the inside information in deciding to trade. For now, I will assume that the SEC’s “knowing possession” interpretation of Rule 10b-5 is in effect. In Part V.B, I will examine the “use vs. possession” debate and explain why the SEC’s “knowing possession” interpretation is more consistent with the “level-playing field” goal of insider trading law than is the “use” interpretation.
However, although Rule 10b-5 prohibits corporate insiders from trading while in possession of material inside information, it does not prohibit them from using such information to abstain from trading. Thus, in certain cases Rule 10b-5 permits corporate insiders to use material inside information to their advantage. For example, a manager of ABC Corp. who is considering selling ABC shares on Monday afternoon learns, shortly before the planned sale, that there is undisclosed good news. That news, which will be disclosed Tuesday, is likely to boost ABC’s stock price. The manager abstains from selling the stock for $10 on Monday and instead sells on Wednesday after the good news has boosted ABC’s stock price to $12. A similarly situated public shareholder, ignorant of the impending good news announcement, sells his stock on Monday afternoon for $10 per share and makes less money selling his shares than the manager.

Because of this “abstention problem,” legal commentators – both those opposed to and those in favor of insider trading regulation – have argued that even if corporate insiders are prevented from trading on inside information, they will still reap greater trading profits than public shareholders. For example, Henry Manne, the earliest and one of the most vocal academic critics 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.7

The first purpose of this paper is to show that the conventional view of insider abstention, which appears to be expressed by every commentator who has addressed the issue, is incorrect. The paper demonstrates, using a simple model, that an insider who is prevented from trading while in possession of inside information cannot systematically earn higher trading profits than a similarly situated public shareholder even though the insider is free to use inside information to abstain from trading. As the paper explains, an insider’s ability to abstain on inside information does nothing more than to compensate the insider for his

inability to trade while in possession of inside information indicating that the trade would be favorable. In fact, without the ability to abstain on inside information, an insider prevented from trading while in possession of inside information would earn lower trading returns than a similarly situated public shareholder.

After considering the distributional effects of insider abstention, I systematically analyze its efficiency effects. The debate over the economic desirability of insider trading focuses largely on how the prospects of such trading affect managers’ incentives and the cost of capital _ex ante_. Supporters of insider trading regulation have argued, for example, that the prospect of insider trading profits might undesirably give managers an incentive to undertake value-decreasing projects. Critics of insider trading regulating claim that insider trading profits might lead risk-averse managers to undertake more value-increasing projects. The paper explains that even if the supporters of insider trading regulation are correct to argue that corporate insider trading is (as I believe) inefficient, insider abstention is likely to be efficient. In particular, insider abstention is likely to improve managers’ incentives, including their incentive to exert effort.

I then turn to examine three policy implications of the analysis. The first implication is that the possibility insider abstention does not, as many commentators appear to believe, limit the effectiveness of insider trading regulation. Contrary to the claims of both supporters and critics of insider trading, the traditional goal of insider trading regulation – leveling the playing field – can be achieved simply by preventing insiders from trading while in possession of inside information. Insider abstention is not, as critics of insider trading regulation argue, a gaping hole that renders Rule 10b-5 largely ineffective at preventing insiders from exploiting their access to inside information. Nor is there any reason, as some on the other side of the debate have argued, to try to develop methods for preventing insider abstention.

The second implication of the analysis relates to the “use vs. possession” debate under Rule 10b-5. The SEC has ruled that an insider trades in violation of Rule 10b-5 if he is in “knowing possession” (or “aware”) of material inside information. Some commentators have argued that there is no violation of Rule 10b-5 unless the insider “uses” the inside information in deciding whether to trade. The courts are split on the issue. I explain that because the “use” standard permits insiders to abstain _and_ trade while in possession of inside information (as long as the decision to trade is not based on this information), standard enables insiders to
outperform similarly situated outsiders. Thus, the “possession” standard assists in promoting one of the traditional goals of inside trading law by “leveling the playing field” between insiders and outsiders.

Next, the paper applies its distributional and efficiency analysis of insider abstention to evaluate Rule 10b5-1(c), the SEC regulation that creates a “safe harbor” from Rule 10b-5 liability. Rule 10b5-1(c) permits insiders to trade while in possession of inside information as long as the trade is pursuant to a pre-arranged plan. However, Rule 10b5-1(c) also permits insiders to cancel pre-arranged trades while in possession of inside information. Therefore, it permits insiders to abstain on inside information. Accordingly, the paper argues that the SEC’s safe harbor regulation permits insiders to outperform public shareholders in their trading. The paper explains that by modifying Rule10b5-1(c) to prohibit insiders from canceling their pre-arranged trades while in possession of inside information, the SEC could create a more level playing field.

The remainder of the paper proceeds as follows. Part II describes the nature of corporate insiders’ informational advantage over public shareholders and explains how Rule 10b-5 reduces this advantage by prohibiting insiders from trading on material inside information. Part III uses a simple model to examine the distributional effects of insiders’ use of inside information to abstain from trading, a use of inside information permitted by Rule 10b-5. The model is used to demonstrate that an insider who is prevented from trading while in possession of inside information but who is free to abstain on inside information cannot systematically outperform a similarly situated public shareholder in his trading. I conclude Part III by showing that an insider who is prevented from trading and abstaining while in possession of inside information would under-perform a similarly situated public shareholder. Part IV turns to the incentive and cost-of-capital effects of insider abstention. I show that none of the adverse effects attributed to corporate insider trading arises from insider abstention. I also demonstrate the desirability of insider abstention from an economic perspective. Part V discusses the implications of the analysis for the effectiveness of insider trading regulation, the “use vs. possession” debate under Rule 10b-5, and the desirability of Rule 10b5-1(c). Part VI concludes.
II. Insiders’ Informational Advantage and the Prohibition Against Insider Trading

This Part briefly describes the nature of insiders’ informational advantage (Section A) and the prohibition against insider trading (Section B).

A. Insiders’ Informational Advantage

Insiders have access to information not available to the public. For example, 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 relationships with the corporation. This information might indicate that the stock price is likely to increase. For example, a corporate insider might learn that last quarter’s earnings are better than expected, that there will be an unanticipated takeover bid, that there has been a significant technological breakthrough, or that an important new customer has been acquired. 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 reduce significantly 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. By selling the stock now rather than waiting until the bad news is released, the CEO can make a profit (by avoiding a loss) of $2 per share.

B. The Prohibition Against Insider Trading

Although corporate insiders inevitably will have an informational advantage over other shareholders, for over sixty years there has been a consensus among the public, Congress, government regulators, and many commentators that these insiders should not be permitted to profit freely from this advantage. The consensus is reflected in a system that attempts to “level the playing field” between corporate 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 1934 Act.


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.
Under the duty to disclose or abstain, a person in possession of “material” nonpublic information must either disclose 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 similar relationship of trust and confidence. The rule applies to corporate insiders trading in their firm’s shares because they owe a fiduciary duty to public shareholders.

Rule 10b-5, which was promulgated by the SEC in 1942, does not expressly prohibit insiders from trading on inside information. However, in 1961, the SEC interpreted the 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” to impose the duty to disclose or abstain. According to the SEC:

11 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, supra note 10, 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). However, as I explain below, the lower courts continue to interpret “materiality” in a manner that enables insiders to profit legally on certain kinds of valuable inside information.

12 See Chiarella v. United States, 445 U.S. 222, 230-31 (1980). The information must indicate that the intended trade would be favorable to the insider. An insider is free to trade while in possession of inside information indicating that the trade would be unfavorable to him.

13 The rule also applies to controlling shareholders, who 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).

14 In In re Cady, Roberts & Co., 40 S.E.C. 907, 911 (1961), the SEC ruled: “Insiders 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
[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 involved where a party takes advantage of such information knowing that it is unavailable to those with whom he is dealing.\textsuperscript{15}

During the last 20 years, Congress has sharply increased civil and criminal penalties for violating Rule 10b-5.\textsuperscript{16} There is evidence that these measures have reduced the amount of illegal insider trading.\textsuperscript{17}

To be sure, Rule 10b-5 cannot always prevent insiders from trading profitably on inside information.\textsuperscript{18} There has been considerable discussion about the rule\textquotesingle s limits. First, Rule 10b-5 will not always stop insiders from illegally trading on material inside information. In particular, there are many situations in which the probability of apprehension and punishment is too low to deter illegal trading.\textsuperscript{19}

\begin{flushleft}
their investment judgment. [If disclosure would be] improper or unrealistic [the insider must] forego the transaction."
\end{flushleft}

\textsuperscript{15} Id. at 912. The duty to disclose or abstain was later adopted by the Second Circuit in \textit{SEC v. Texas Gulf Sulphur}, 401 F.2d 833, and was acknowledged implicitly by the Supreme Court in \textit{Chiarella v. United States}, 445 U.S. 222, which conditioned the duty on the existence of a fiduciary or other special relationship between the parties.

\textsuperscript{16} In 1984, Congress enacted the Insider Trading Sanctions Act (\textquotedblleft ITSA\textquotedblright), 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. \textit{See} Insider Trading Sanctions Act, 15 U.S.C. § 78u-1(a)(2) (1984). In 1988, Congress passed the Insider Trading and Securities Fraud Act (\textquotedblleft ITSFEA\textquotedblright), which increased criminal penalties (for natural persons) from $100,000 to $1 million and raised maximum prison sentences from five to ten years. \textit{See} Insider Trading and Securities Fraud Enforcement Act, 15 U.S.C. § 78f(a) (1988). 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. \textit{See} O'Connor, \textit{supra} note 10, at 336-337.


\textsuperscript{18} \textit{See} Id.

\textsuperscript{19} \textit{See} Manne, \textit{supra} note 7, at 937 (noting that the \textquoteleft ability to detect [insider trading] will
Second, lower courts have been reluctant to find information “material” unless it concerns a “bombshell event”\textsuperscript{20} – such as the definite existence of a takeover offer – whose announcement causes the stock price to move very sharply in one direction or the other.\textsuperscript{21} Thus, Rule 10b-5 enables insiders to make profits by trading legally on important but “sub-material” inside information.\textsuperscript{22}

However, the conventional wisdom is that even if the enforcement and materiality gaps were closed, insiders still would be able to outperform public shareholders in their trading because of their ability to abstain based on inside information. Thus, I will assume, for purposes of showing that the conventional wisdom is incorrect, that Rule 10b-5 does prevent insiders from trading while in possession of inside information. That is, I will assume that Rule 10b-5 can be enforced perfectly and that it applies to all inside information on which one could trade profitably. Under this assumption, we shall see that insiders cannot outperform public shareholders in their trading, even though they are completely free to abstain on inside information.

### III. The Distributional Effects of Insider Abstention

The purpose of this Part is to examine the distributional effects of insider abstention, by which I mean insiders’ ability to outperform public shareholders in their trading because of the insiders’ ability to abstain on inside information.\textsuperscript{23} Section A describes the received wisdom on the subject: that even if insiders are prevented from trading while in possession of inside information, they nevertheless are able to outperform public shareholders in their trading because they can use inside information to abstain from trading. Section B offers a numerical example to explain why, in fact, the ability of such insiders to engage in insider abstention does


\textsuperscript{21} See Fried, supra note 17, at 335-337.

\textsuperscript{22} See Fried, supra note 17; Carlton & Fischel, supra note 20.

\textsuperscript{23} Public shareholders might be compensated \textit{ex ante} (through a lower stock price) for any \textit{ex post} losses they expect suffer as a result of insiders’ use of inside information.
not enable them to earn greater trading returns than public shareholders. Section C presents a simple formal model and uses it to show that insiders prevented from trading while in possession of inside information will not make more trading profits than public shareholders. The model is also used to show that insiders who are prevented from trading and abstaining on inside information systematically would underperform public shareholders in their trading.

A. The Conventional Wisdom: Insider Abstention Enables Insiders to Earn Higher Trading Returns

Legal commentators have long assumed, and in many cases affirmatively argued, that even if insiders are prevented from trading while in possession of inside information, they still retain an advantage over public shareholders because they can use inside information to abstain from trading.24

The example presented in the Introduction illustrates their thinking. Suppose that the CEO of ABC Corp. intends to sell 1 million shares Monday afternoon. On Monday morning, several hours before the planned sale of the stock, the CEO learns that last quarter’s earnings are substantially higher than expected. The stock is trading for $10 per share. The earnings announcement, which is to be released Tuesday, 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 Tuesday, boosting the stock price to $12. The CEO then sells his 1 million shares for $12 each on Wednesday, for a total of $12 million.

Compare the abstaining CEO to a similarly situated public shareholder who intends to sell 1 million shares for $10 on Monday afternoon and does not have the same inside information. Unaware that the stock price is likely to increase Tuesday, the public shareholder does not abstain from selling the stock on Monday. He sells his shares for $10 per share Monday afternoon, for a total of $10 million. Inside information thus enables the CEO to make $2 million more than the similarly situated public shareholder selling his stock. However, the CEO does not violate Rule 10b-5. There is no violation because the CEO does not trade while in possession of inside information. He abstains on inside information, and trades only once the information has been released and become reflected in the stock price.

Not surprisingly, there is evidence consistent with insiders using inside information in this very manner. For example, there is evidence that insiders of over-the-counter (OTC) listed firms who know their shares will be listed soon on the NYSE or AMEX postpone sales until after the relisting announcement.\textsuperscript{25} In addition, insider selling tends to take place after there have been positive abnormal returns and insider buying tends to take place after there have been negative abnormal returns.\textsuperscript{26} The trading pattern is consistent with insiders abstaining on inside information until the price becomes more favorable to them.\textsuperscript{27}

Because of this “abstention problem,” legal commentators – both those favoring insider trading regulation and those opposed to it – have argued that insiders retain an advantage over public shareholders even if the insiders are prevented from trading on inside information. 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.\textsuperscript{28}

Manne had previously 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 \textit{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 \textit{buy} shares. The economic effect, in any event, is the same.\textsuperscript{29}


\textsuperscript{27} This pattern is also consistent with insiders opportunistically selling (buying) when the stock has become overpriced (underpriced).

\textsuperscript{28} Manne, \textit{supra} note 7, at 938.

In a similar vein, Judge Richard Posner has written:

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.30

Similar views also have been expressed by commentators favoring even stricter insider trading regulation. According to one such commentator, Professor Stephen Salbu,

‘[I]nsider 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.31

German commentators have expressed this view as well. Whereas Rule 10b-5 clearly permits insider abstention, the German Securities Trading Act, which outlaws the “exploitation” of inside information, is apparently ambiguous on this

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issue. Thus, certain German commentators have argued that the German Securities Trading Act should be read as outlawing all exploitation of inside information, even insider abstention. 32

B. Why the Conventional Wisdom is Wrong

Consider again the CEO of ABC Corporation and a similarly situated public shareholder, both intending to sell one million shares Monday afternoon. In the example above, the CEO learns Monday morning that earnings are substantially higher than expected and that this good news will be released Tuesday. The market price is $10 per share. He abstains from selling until after the good news is released and the price has risen to $12 per share. He thus makes $2 million more in selling his stock than the similarly situated public shareholder who, not knowing of the imminent announcement of good news, sells his one million shares for $10 per share. As this example illustrates, an insider planning to sell shares can earn higher returns than the similarly situated public shareholder by abstaining from selling when he learns that good news will emerge shortly and boost the stock price.

But suppose the insider intending to sell shares learns that bad news will emerge shortly and reduce the stock price. In this situation, selling before the bad news is made public would constitute illegal trading while in possession of inside information. Thus, the insider is prohibited from selling his shares until the bad news has been released and the stock price has fallen. As a result, the insider is forced to postpone the sale until the bad news is disclosed, and must sell his shares at the lower, post-disclosure price.

32 See Hartmut Krause, The German Securities Trading Act (1994): A Ban on Insider Trading and an Issuer’s Affirmation Duty to Disclose Material Nonpublic Information, INT’L LAW. (1996) (reporting that other commentators have suggested the German Securities Trading Act’s prohibition against exploitation of inside information “. . . 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,” but arguing that “there should be no grounds to punish loss-avoiding insider abstention”); Peter M. Memminger, The New German Insider Law: Introduction and Discussion in Relation to United States Securities Law, 11 FLA. J. INT’L L. 189 (1996). (asserting that although “it would have been sound from a theoretical point of view to include a provision covering non-selling or non-purchasing (on inside information), the [German Securities Trading] Act’s limitation to affirmative acts seems justifiable [because of enforcement limitations]”).
Suppose, for example, that on Monday morning, the CEO learns that last quarter’s earnings are substantially lower than expected. The earnings announcement, which is to be released Tuesday, is likely to cause the market price (currently $10) to fall significantly. The CEO cannot sell his shares on Monday afternoon 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 Tuesday, reducing the stock price to $8. The CEO then sells his one million shares for $8 each for a total of $8 million.

Compare the CEO to the similarly situated public shareholder who also intends to sell one million shares for $10 on Monday afternoon 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 Monday afternoon, for a total of $10 million. Thus having inside information costs the CEO $2 million in selling his stock.

Thus, in the bad news scenario, 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 has dropped. In short, the insider’s ability to abstain on inside information indicating that a planned trade would be unfavorable compensates the insider for his inability to trade while in possession of inside information indicating that the planned trade would be favorable.

C. Analyzing Insider Trading and Abstention With a Simple Model

This Section presents a simple formal model to illustrate the effect of insiders’ ability to trade and/or abstain while aware of inside information on their trading profits. It then uses the model to examine insiders’ trading returns under four scenarios.

Scenario 1: No inside information

In the first scenario, insiders are not aware of any inside information. Under this scenario, it is shown, insiders expect to earn the market rate of return on their trading.
Scenario 2: Insider abstention and insider trading

In the second scenario, insiders are aware of inside information, and are free to trade or abstain on that information. The model is used to demonstrate that, under this second scenario, insiders expect to systematically beat the market.

Scenario 3: Insider abstention and no insider trading

In the third scenario, insiders are aware of inside information, but they are prevented from trading while aware of this information. This rule reflects the current insider trading regime under Rule 10b-5 (assuming perfect enforcement and a sufficiently low “materiality” standard). Under this third scenario, it is shown, insiders cannot systematically beat the market – they can expect only to earn market returns.

Scenario 4: No insider abstention and no insider trading

The final scenario replicates what certain academic commentators in and outside the United States consider to be the “ideal” regime: insiders are prevented both from trading and abstaining while aware of inside information. I show that under such a regime insiders would systematically underperform the market in their trading.

1. The Model

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>T0</td>
<td>T1</td>
<td>T2</td>
</tr>
<tr>
<td>Insider decides to trade at T2</td>
<td>Insider may get information</td>
<td>Insider trades or abstains</td>
</tr>
<tr>
<td>(subject to law)</td>
<td>Insider trades</td>
<td>Insider cashes out</td>
</tr>
</tbody>
</table>

At T0, an insider of ABC Corp. (“ABC”) tentatively decides to sell (buy) ABC shares at T2. Whether or not he sells (buys) the shares at T2 will depend on two factors: (1) any private information regarding the value of ABC received at T1; and (2) any legal restrictions on his trading in ABC stock at T2.

If the insider sells ABC shares at T2, he will invest the proceeds in shares of a market-wide index fund until T3, at which point he will liquidate his shares in the fund. If the insider buys ABC shares at T2, he will sell shares in the market-wide
index fund to finance the purchase. During the period between T2 and T3, the market is expected to earn a return M%. At T3, the insider liquidates all his investments (ABC shares and/or index fund shares).

If the ABC insider becomes aware of inside information at T1, that inside information will indicate whether ABC shares are likely to outperform (or underperform) the market between T2 and T3. I assume the information, if any, indicates with certainty whether ABC shares will outperform or will underperform the market.33

The ex ante likelihood that ABC shares will outperform the market between T2 and T3 is p. The expected amount of “abnormal” positive returns (the degree to which ABC beats the market), given that ABC outperforms the market, is X%. In other words, if ABC is outperforms the market, its expected return is (M+X)%. The likelihood that ABC shares will underperform the market between T2 and T3 is (1-p). The expected amount of “abnormal” negative returns (the degree to which ABC underperforms the market), given that ABC underperforms the market, is Y%. Therefore, if ABC will underperform the market, its expected return is (M-Y)%. I assume that (p)(X%) = (1-p)(Y%). In other words, ABC’s expected return is neither lower nor higher than the market’s expected return.34 It follows that Y = [p/(1-p)]X.

We will now examine the return earned by the ABC insider under varying assumptions about his receipt of inside information and the legal restrictions on his trading.

33 The assumption of certainty is made only for simplicity and is not necessary for the results generated by the model. The results would be the same if the information were merely probabilistic. For example, the results would be the same if the “good news” information indicated that there was a (say) 70% chance that ABC stock would outperform the market and a 30% chance that ABC stock would underperform the market, and the “bad news” information indicated that there was a 70% likelihood that ABC stock would underperform the market and a 30% likelihood that ABC stock would outperform the market. The results would also be the same if the insiders’ ability to process the inside information were limited and, as a result, the insider were correct in his assessments as to whether or not ABC stock would outperform the market less than 100% of the time.

34 If ABC’s expected return, based on public information, were either higher or lower than the market return, investors would either buy or sell the stock until the price was such that the expected return equaled that of the market.
2. The Insider’s Performance in the Absence of Inside Information

Suppose that the ABC insider has no inside information.

<table>
<thead>
<tr>
<th>SELLING SCENARIO</th>
<th>Probability</th>
<th>T₂ Insider action</th>
<th>Expected Return</th>
</tr>
</thead>
<tbody>
<tr>
<td>ABC will outperform market</td>
<td>p</td>
<td>Sell ABC stock</td>
<td>M%</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Buy index</td>
<td></td>
</tr>
<tr>
<td>ABC will underperform market</td>
<td>1-p</td>
<td>Sell ABC stock</td>
<td>M%</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Buy index</td>
<td></td>
</tr>
</tbody>
</table>

_Selling_. First consider the case in which the ABC insider becomes inclined to sell ABC shares. In the absence of inside information, the ABC insider who decides at T₀ to sell ABC shares at T₂ will proceed with the sale and invest the proceeds in the market-wide index fund. During the period between T₂ and T₃, the insider thus expects to earn the market return.

<table>
<thead>
<tr>
<th>BUYING SCENARIO</th>
<th>Probability</th>
<th>T₂ Insider Action</th>
<th>Expected Return</th>
</tr>
</thead>
<tbody>
<tr>
<td>ABC will outperform market</td>
<td>p</td>
<td>Buy ABC stock</td>
<td>(M+X)%</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Sell index</td>
<td></td>
</tr>
<tr>
<td>ABC will underperform market</td>
<td>1-p</td>
<td>Buy ABC stock</td>
<td>(M-Y)%</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Sell index</td>
<td></td>
</tr>
</tbody>
</table>

_Buying_. Next consider the case in which the ABC insider becomes inclined to buy ABC stock. In the absence of inside information, the ABC insider who decides at T₀ to buy ABC shares at T₂ will proceed with the sale of index fund shares and use the proceeds to purchase ABC shares. Because ABC’s expected return is assumed to
be the same as that of the market, the insider expects to earn the market return for
the period between $T_2$ and $T_3$ after purchasing ABC shares.

3. The Insider’s Performance Under an “Abstain/trade” Regime

Now suppose that the insider receives, at $T_1$, inside information about the
expected performance of ABC shares during the period $T_2$ and $T_3$. And suppose that the insider is permitted to trade or abstain while aware of this information.

<table>
<thead>
<tr>
<th>SELLING SCENARIO</th>
<th>Probability</th>
<th>$T_2$ Insider Action</th>
<th>Expected Return</th>
</tr>
</thead>
<tbody>
<tr>
<td>ABC will outperform market</td>
<td>$p$</td>
<td>Insider retains ABC stock</td>
<td>$(M+X)%$</td>
</tr>
<tr>
<td>ABC will underperform market</td>
<td>$1-p$</td>
<td>Sell ABC stock</td>
<td>$M%$</td>
</tr>
</tbody>
</table>

Selling. Consider first the case in which the insider is intending to sell ABC shares. If the insider learns that ABC will outperform the market, he will not go through with his planned sale of ABC shares. Instead, he will hold on to those shares and plan to sell them at $T_3$, after they have outperformed the market. His expected return during the period $T_2$ and $T_3$ therefore will be $(M+X)\%$.

If, on the other hand, the insider learns that the shares will underperform the market, he will sell the shares as he had intended and buy shares in the market-wide index fund. His expected return during the $T_2$ and $T_3$ period therefore will be $M\%$, the expected market return.

Thus, in a regime where the insider can abstain and trade while aware of inside information, the insider will (before knowing whether ABC will outperform or underperform the market) expect to earn a return of $(M + pX)\%$, which is higher than the expected market return.

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35 The insider’s expected return before knowing whether he will learn that the news is good or bad is $p(M+X)\% + (1-p)(M)\%$, which simplifies to $(M + pX)\%$. 

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Note that if the insider considering selling stock learns that ABC stock will outperform the market, he might not only retain his ABC shares but also purchase additional shares (or call options). This would further boost his insider trading profits. Similarly, if the insider considering selling ABC stock learns that ABC stock will underperform the market, he might not only sell the shares he was planning to sell but also sell additional shares, sell the stock short, or buy put options. However, even if the insider does nothing more than abstain from selling when he learns good news and proceed with selling when he learns bad news, he will expect to earn abnormal positive returns.

<table>
<thead>
<tr>
<th>BUYING SCENARIO</th>
<th>Probability</th>
<th>T₂ Insider Action</th>
<th>Expected Return</th>
</tr>
</thead>
<tbody>
<tr>
<td>ABC will outperform market</td>
<td>p</td>
<td>Buy ABC stock sell index</td>
<td>(M+X)%</td>
</tr>
<tr>
<td>ABC will underperform market</td>
<td>1-p</td>
<td>Doesn’t buy ABC stock</td>
<td>M%</td>
</tr>
</tbody>
</table>

Buying. Next consider the case in which the insider is considering buying stock. If the insider learns that ABC stock will outperform the market, he will proceed with his plans to buy the stock, and expect a return of (M+X)%. If, on the other hand, the insider considering buying learns that ABC stock will underperform the market, he will abstain from purchasing the stock and keep his money in a market-wide mutual fund. In this case, his expected return during the period T₂ and T₃ will be M%.

Thus, the insider will, (before learning whether the stock will outperform or underperform the market) expect to make a return of (M+pX)%, which is higher than the market return (and equal to his expected return when he is considering selling rather than buying ABC stock).

Again, an insider planning to buy stock who learns that there is good news might consider buying even more stock or also buying call options. Similarly, if learns of bad news he might not only abandon his plan to buy shares, but also sell
shares, sell the stock short, or buy puts. The point is that even if the insider contemplating buying stock does nothing more than abstain from or proceed with the purchase while aware of inside information, he will expect to earn market-beating returns.

4. The Insider’s Performance Under an “Abstain/no-trade” Regime

We now consider the insider’s trading performance under a regime in which he can abstain while aware of inside information but cannot trade while aware of inside information. This is the regime that would prevail under Rule 10b-5 if (a) any item of information on which one could profitably trade would be considered “material”; (b) Rule 10b-5 could be perfectly enforced; and (c) the SEC’s “knowing possession” standard for liability were in effect.

<table>
<thead>
<tr>
<th>SELLING SCENARIO</th>
<th>Probability</th>
<th>T₂ Insider Action</th>
<th>Expected Return</th>
</tr>
</thead>
<tbody>
<tr>
<td>ABC will outperform market</td>
<td>p</td>
<td>Insider abstains from selling ABC stock</td>
<td>(M+X)%</td>
</tr>
<tr>
<td>ABC will underperform market</td>
<td>1-p</td>
<td>Insider cannot sell ABC stock</td>
<td>(M-Y)%</td>
</tr>
</tbody>
</table>

_Selling._ Begin with the situation in which the insider is planning, at T₀, to sell shares of ABC at T₂. He then receives information at T₁ indicating either that ABC will outperform the market or that it will underperform the market. If he receives information indicating that ABC will outperform the market, the insider abstains from selling ABC shares, and will expect to earn (M+X)% on those shares during the T₂ and T₃ period.

If he instead learns bad news, the insider would like to proceed with his planned sale but is prevented from doing so while in possession of inside information suggesting that the sale would be favorable to him. He must hold on to the ABC shares, and expects to earn a return of (M-Y)%.
that $Y$ is defined as the amount by which ABC underperforms the market, given that ABC underperforms the market.

The insider intending to sell ABC shares will therefore choose to or be forced to retain those shares. Because by assumption the expected return of ABC shares, based on public information, equals the market rate of return, the insider holding the ABC shares on average will expect to earn the market return.

<table>
<thead>
<tr>
<th>BUYING SCENARIO</th>
<th>Probability</th>
<th>$T_2$ Insider Action</th>
<th>Expected Return</th>
</tr>
</thead>
<tbody>
<tr>
<td>ABC will outperform market</td>
<td>$P$</td>
<td>Insider cannot buy ABC stock</td>
<td>$M%$</td>
</tr>
<tr>
<td>ABC will underperform market</td>
<td>$1-p$</td>
<td>Insider abstains from buying ABC stock</td>
<td>$M%$</td>
</tr>
</tbody>
</table>

Buying. Next consider the case in which the insider is planning to buy ABC shares. If he learns good news – that ABC will outperform the market – he is prevented from going through with his planned purchase. He therefore will hold on to the shares in the market-wide mutual fund that he was going to sell to finance the purchase of the stock, and expect to earn the market return, $M\%$.

If he learns bad news, the insider will abstain from the purchase of the ABC shares. He again will hold on to his mutual fund shares, and expect to earn the market return $M\%$. Thus under an abstain/no-trade regime, the insider inclined to buy shares will expect to earn the market return $M\%$.

5. The Insider’s Performance Under a “No-abstain/no-trade” Regime

As noted in the introduction, many commentators have argued that even if insiders could be prevented from trading while in possession of inside information, their ability to abstain on inside information confers on them a trading advantage over public shareholders. A number of these commentators have argued that it
therefore would be desirable, if possible, to prevent insiders from abstaining on inside information.

We saw in Part III.C.4 that if insiders could not trade while aware of inside information indicating that the trade would be favorable, their ability to abstain from trading on inside information does not give them the ability to systematically beat the market return. I will now use the model to show that, if insiders could neither trade nor abstain while aware of inside information, they would systematically expect to earn below market returns.

<table>
<thead>
<tr>
<th>SELLING SCENARIO</th>
<th>Probability</th>
<th>T2 Insider Action</th>
<th>Expected Return</th>
</tr>
</thead>
<tbody>
<tr>
<td>ABC will outperform market</td>
<td>p</td>
<td>Insider cannot abstain from selling ABC stock</td>
<td>M%</td>
</tr>
<tr>
<td>ABC will underperform market</td>
<td>1-p</td>
<td>Insider cannot sell ABC stock</td>
<td>(M-Y)%</td>
</tr>
</tbody>
</table>

Selling. Consider an insider hoping to sell shares. If he learns bad news, he will be prevented from selling the shares because he is aware of inside information indicating that the trade would be favorable. His expected return from holding the shares will thus be (M-Y)%.

If he learns good news, he would like to abstain from selling shares, but under a no-abstain/no-trade regime he would be prevented from abstaining on such information. As a result, he would be forced to sell his shares. The proceeds would be invested in shares in the market-wide index fund. His expected return in this situation therefore would be M%, the expected market return.

Before knowing whether there will be good or bad news, the insider would expect to earn a return (M-[1-p]Y)%,36 which is below the expected market return. The reason the insider expects to earn below market returns is that the no-trade regime imposes a disability on the insider by preventing the insider from going

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36 The insider expects a return of pM% + (1-p)(M-Y)%, which simplifies to (M-[1-p]Y)%.
through with a sale when he learns bad news, and does not compensate for that disability by allowing the insider to abstain from selling when he learns good news.

<table>
<thead>
<tr>
<th>BUYING SCENARIO</th>
<th>Probability</th>
<th>T₂ Insider Action</th>
<th>Expected Return</th>
</tr>
</thead>
<tbody>
<tr>
<td>ABC will outperform market</td>
<td>p</td>
<td>Insider cannot buy ABC stock</td>
<td>M%</td>
</tr>
<tr>
<td>ABC will underperform market</td>
<td>1-p</td>
<td>Insider cannot abstain from buying ABC stock</td>
<td>(M-Y)%</td>
</tr>
</tbody>
</table>

Buying. Now consider an insider hoping to buy shares. If he learns bad news, he would like to abstain from the purchase, but under the no-abstain component of a no-abstain/no-trade regime would be prevented from doing so. As a result, he would be forced to purchase the stock, and would expect to earn a return of (M-Y)%.

If the insider learns good news, he would like to proceed with the purchase, but under the no-trade component of such a rule would be prevented from doing so. As a result, the insider will hold on to his shares in the market-wide index fund, and expect to earn a return of M%. Before learning whether there is good news or bad news, he will expect to earn (M-[1-p]Y)%, which is less than the market return.

Thus, as is the case of an insider hoping to sell shares, under a no-abstain/no-trade regime an insider hoping to buy shares will systematically underperform the market.

6. What if the insider acquires inside information only when there is good (bad) news?

One might wonder whether the model’s results still would hold if the insider were more likely to get inside information in some situations than in others. For example, suppose that the insider is more likely to acquire specific inside information (e.g., about unexpected earnings results) when there is good news
(indicating the stock will outperform the market) than when there is bad news (indicating that the stock will underperform the market). Although there is no a priori reason to expect there to be such an asymmetry in the acquisition of specific inside information, such an asymmetry is possible. As we will see, however, even if such an asymmetry exists, the model’s results still hold: insiders cannot systematically beat the market by abstaining when they are prevented from trading while in possession of inside information.

Consider again the ABC insider. Suppose, for simplicity, that the insider sometimes learns about undisclosed good news but never learns about undisclosed bad news. Suppose further that the insider intends to sell shares. One might reason as follows: If, before selling the shares, he learns good news, he can abstain legally and beat the market. Otherwise, not knowing any bad news, the insider is legally able to sell his stock, buy shares in the market-wide index fund, and earn the market return. Thus, the insider should be able to systematically beat the market – merely by using inside information to abstain legally from selling.

Obviously, if the ABC insider buys ABC shares as much as he sells ABC shares, then the benefit the information asymmetry appears to provide when he sells shares is offset by the cost the information asymmetry imposes on him when he buys shares. If the insider receives inside information only when there is good news, the insider will be prevented from buying when he learns that ABC will outperform the market. He must thus hold on to the shares in his market-wide index fund and earn the market return. But if the insider is unaware when there is bad news, he will proceed with his purchase of ABC stock, and earn a below-market return on the investment. On average, the ABC insider will earn a below-market return on his purchases. And this will exactly offset his above-market return on his sales.

But suppose, for example, that the ABC insider never buys ABC shares; he only sells them. Under this assumption, could the ABC insider then systematically beat the market if he learns only of good news? The answer is, perhaps surprisingly, still “no.” The reason is as follows: If the insider knows that he only learns inside information when there is good news, the absence of good news itself provides private information to the insider about the expected return of ABC relative to the market. And, under the paper’s assumption that the insider is prevented from trading when in possession of inside information indicating that the trade would be
favorable, the insider therefore could not sell the stock if he learns that there is no good news.

The signal provided by the absence of good news is easy to see by slightly modifying the model. In the settings where the insider receives inside information, the model has assumed that there are two possibilities - (1) the insider learns inside information indicating that ABC will outperform the market, and (2) the insider learns inside information indicating that ABC will underperform the market. Suppose instead that the insider receives specific inside information indicating ABC’s expected return only when there is good news. When there is bad news, the insider learns no specific inside information indicating that ABC’s expected return is below that of the market. Thus, it would seem, the ABC insider could abstain legally from trading when there is good news, and sell legally when there is bad news. However, if the insider knows that he receives specific inside information only when there is good news, he can infer from the absence of such information that there is bad news. Consequently, the absence of good news is equivalent to learning bad news about ABC’s expected return. Under the assumption that the insider cannot trade while in possession of private information indicating that the trade would be favorable, the insider could not sell ABC shares when there is an absence of good news. Thus, the insider would choose to hold onto his ABC shares when they will outperform the market, but must hold on those shares when they will underperform the market.

One might argue that this simple asymmetric news model is unrealistic because there are likely to be situations where the absence of good news does not automatically imply that there is bad news. Suppose, for example, that (1) when there is good news, and there is an X% likelihood that the insider will learn of that good news; and (2) when there is bad news, the insider receives no signal as to ABC’s expected return. Now, the insider cannot infer from the absence of a signal that there is bad news - because there is some likelihood that there is good news of which the insider is not aware. But the absence of good news still reveals that ABC, on an expectation basis, will underperform the market. As a result, the insider will have private information indicating that, on an expectation basis, he will earn a higher return by selling his shares than by keeping them - and, under the paper’s assumptions, the possession of that information will preclude him from trading.

To be sure, trading on the absence of specific information indicating the stock will outperform the market is unlikely to be illegal. And therefore the insider might
be permitted to sell in situations where he can infer that the stock, on an expectation basis, will underperform the market. If so, the insider could, on average, beat the market.

But trading on the absence of inside information indicating good news would be legal only if the information in the insiders’ possession – that he has not learned any good news -- is considered not to be “material.” As Part II.B. explained, there is no question that insiders can and do systematically beat the market while trading on inside information relating to the expected return of the stock that fails to meet the relatively high “materiality” standard. The interesting question is: if the “materiality” standard is sufficiently low to forbid trading while aware of any information indicating that the stock is likely to outperform or underperform the stock market, can an insider earn higher returns by using inside information to abstain from trading? The conventional answer is “yes.” The analysis offered here shows that the correct answer is “no” – and that this answer does not depend on there being symmetry in the inside information received by the insider.

IV. The Efficiency Effects of Insider Abstention

After having considered the distributional effects of insider abstention, we now turn to its efficiency effects. There is an ongoing academic debate about the economic desirability of insider trading. Supporters of insider trading regulation argue that insider trading distorts managers’ incentives, while critics of regulation argue that insider trading could improve them. There is also disagreement over the effect of insider trading on the cost of capital – with supporters of regulation claiming that insider trading increases the cost of equity capital and critics arguing that it does not. Section A shows that the efficiency arguments made by those critical of insider trading generally do not apply to insider abstention. Therefore, even if insider trading is economically undesirable, it does not follow that insider abstention is as well. In fact, as I show in Section B, insider abstention tends to improve managers’ incentives (relative to a no-abstain/no-trade regime).

A. Why The Efficiency Objections Against Insider Trading Don’t Apply to Insider Abstention

This Section shows that the efficiency objections against insider trading do
not apply to insider abstention. I first consider the arguments that insider trading distorts managers’ incentives, and show that insider abstention does not give rise to any of these possible distortions. I then examine the argument that insider trading increases the cost of equity capital, and explain why insider abstention does not give rise to a similar effect. For purposes of this Section, I assume these economic objections to insider trading are valid. The purpose of this Section is to demonstrate that, even if insider trading is economically undesirable for all of the reasons that have been advanced by supporters of insider trading regulation, insider abstention is likely to be desirable.

1. The Potentially Adverse Effects of Insider Trading on Managerial Incentives

Critics of insider trading have argued that insider trading can adversely affect managers' incentives and thereby hurt corporate performance and shareholders. Those opposed to insider trading argue that insider trading might distort managerial incentives in five different ways: (1) by inducing managers to engage in overly risky projects designed to generate large price swings; (2) by causing managers to “waste” value; (3) by giving managers an incentive not to share information internally within the firm; (4) by giving managers an incentive to delay disclosure of news to the market and an incentive to generate rumors; and (5) by giving managers an incentive to invest in projects that are difficult for outsiders to value, and thus give rise to exploitable mispricing. Supporters of insider trading have disputed these claims. We will now see, however, that even if the critics of insider trading are correct, and insider trading distorts managerial incentives, these costs do not arise from insider abstention.

a. Excessive Risk Taking

Critics of insider trading have argued that the prospect of insider trading profits might induce managers to engage in overly risky projects.37 If the risky

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project succeeds, managers can sell their shares at a high price after the good news has been released. If, as is likely in a very risky project, the project fails, the managers can sell their shares before the bad news about the failure is made public. By selling before the bad news is released, the managers are able to avoid bearing much of the cost associated with the project’s failure.

I will use a numerical example to illustrate the distortion in project choice that might arise from managers’ abilities to trade on inside information, and then show that the distortion does not arise from insider abstention. Suppose that managers must choose between two projects: Project A and Project B. If Project A is undertaken, there is a 50% chance that it will succeed and that the stock will trade for $30. There is also a 50% chance that Project A will fail and the stock will trade for $10. If the firm announces that it will pursue Project A, the stock price will be $20 (the expected value of the stock) until the results of the project are announced. If Project B is undertaken there is a 100% chance that the project will succeed and that the stock will trade for $22. If the firm announces that it will pursue Project B, the stock price will jump to $22. From the perspectives of shareholder wealth maximization and efficiency, Project B dominates Project A.

However, suppose managers can trade on inside information after they know whether Project A has succeeded but before the success or failure of Project A is announced. In that case, if Project A is undertaken the managers will buy additional shares when they learn that Project A has succeeded, and sell their shares when they learn that it has not. Suppose that managers currently own one million shares (and not other assets) and could borrow $20 million, enough to purchase one million additional shares at a price of $20 per share. If the managers know Project A has succeeded, they will keep the one million shares they currently own and, before

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 (1967) (managers permitted to trade on inside information will run company to maximize insider trading opportunities rather than to maximize shareholder value).

However, other commentators have argued that the prospect of insider trading profits could improve risk-averse managers’ project choice by rewarding them for choosing higher-risk, higher-value projects. See Carlton & Fischel, supra note 20; Lucian Arye Bebchuk and Chaim Fershtman, The Managerial Choice Among Risky Projects, 29 J. Fin. Quantitative Analysis 1 (1994) (presenting a model in which insider trading can either worsen or improve risk averse managers’ project choice).
announcing Project A’s success, purchase an additional one million shares for $20 each. After Project A’s success has been announced, the managers will own shares worth $60 million (two million shares trading at $30 each), owe $20 million, and therefore have a net worth $40 million. If they know Project A will fail, they will sell one million shares for $20 each and have $20 million in cash. Thus, the expected value of Project A to the managers is $30 million ($40 million + $20 million). The expected value of Project B to the managers is $22 million. Thus, the managers will choose lower-value Project A because it enables managers to make insider trading profits.

Now suppose that the managers cannot trade on inside information but can abstain based on inside information. There are two situations in which they might wish to abstain based on inside information, after having initiated Project A: (1) they plan to buy additional shares, but then learn that Project A has failed; and (2) they plan to sell their shares, but then learn that Project A has succeeded. If they plan to buy additional shares, but before doing so learn that Project A has failed, they will abstain from the purchase and will own (only) one million shares worth $10 million (rather than own two million shares worth $20 million and owe $20 million in cash, for a net position of $0). If they plan to sell their shares but before doing so learn that Project A has succeeded, they will abstain from the sale and own 1 million shares worth $30 million (rather than own zero shares and $20 million in cash). Thus, when managers cannot trade on inside but can abstain, the expected value to the managers of Project A is $20 million. As a result, they will choose Project B, which will leave them with 1 million shares worth a total of $22 million. In short, when managers can abstain based on inside information but cannot trade on inside information, they will not have an incentive to choose inefficiently a low-value, high risk project over a high-value low risk project.

The intuition here is that insider abstention, unlike insider trading, does not permit the managers to decouple their financial fate from that of the public shareholders. While insider trading enables the managers to make additional profits before releasing good news and to avoid losses before bad news is released, the effect of abstention is to enable managers to (a) reap no more and no less than their pro rata share of the gain associated with the good news that they generate and (b) bear (no more and no less than) their pro rata share of the loss associated with the bad news they generate. Thus, insider abstention does not distort managers’ choice of projects.
b. Destruction of Value

It has been suggested that if managers can sell short or buy puts they might have an incentive to destroy corporate value in order to reduce the stock price and profit from their short positions. In the United States, high-level managers are not permitted to sell short or buy puts. Thus, this distortion is unlikely to arise, at least in the United States. However, whether or not this distortion is likely to arise from insider trading, it cannot arise from insider abstention.

In order for there to be an incentive to waste value, managers must be able to make more money by reducing the stock price than by not reducing the stock price. Suppose again that the managers own one million shares, and the stock is currently trading for $20 per share. Suppose further that they can buy, with borrowed funds, an additional one million shares for $20 per share, and that they have the ability to destroy $10 per share of firm value and thereby reduce the share price to $10. Assume that if the managers do nothing the stock will be worth $20 per share.

First, consider a situation in which the managers can engage in insider trading. That is, suppose that managers could sell their shares, sell short, and buy puts on inside information. After planning to reduce the value of the firm to $10 per share, the managers could sell their one million shares for $20, buy puts or sell additional shares short, and then reduce the value of the firm to $10 per share, emerging with $20 million in cash from the sale of their one million shares and any profits they make from short selling (or buying puts). Because they could make more money by selling short and reducing the stock price than by maintaining the firm’s value at $20 per share, they would have an incentive to waste firm value.

Let us now examine whether insider abstention could have a similar effect. There are only two situations in which managers can benefit by insider abstention: (1) by not buying stock before the price falls, or (2) by not selling stock before the price increases. We can ignore the second type of insider abstention, which is not relevant in this example and in any event would make increasing the stock price – not reducing it – relatively more attractive. Thus, the only question is whether

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38 See Lucian Arye Bebchuk & Chaim Fershtman, Can Insider Trading Lead Insiders to Waste Corporate Value? (Working Paper, 1996) (managers who are permitted to sell short might have an incentive to waste corporate value.).
insiders’ ability to avoid buying stock before the stock price falls can give insiders an incentive to reduce the stock price.

Returning to our example, suppose that managers cannot sell on inside information but can avoid buying stock before the price falls. It is easy to see that the managers will not have an incentive to cause the stock price to decline to $10 per share. If they do nothing, the stock will be worth $20 per share, and they will hold one million shares of stock worth $20 million. If they cause the price of the stock to fall to $10, they will abstain from buying any additional shares, but they will still own one million shares, and those shares will be worth only $10 million. Thus, they are better off doing nothing.

To be sure, if managers could not abstain from buying shares when they know the price would fall, reducing the stock price would make them even worse off. For example, if they were forced to purchase an additional one million shares for $20 per share even when they knew that the stock price would fall to $10 per share, they would own two million shares worth $20 million and owe $20 million, and thus have a net worth of $0.

However, the point is that even with the benefit of insider abstention the managers have an incentive not to waste corporate value. Thus, insider abstention – unlike insider trading – cannot provide managers with an incentive to destroy corporate value.

c. Disruption of Internal Communications

It has been said that insider trading also could interfere with internal firm communications by giving managers an incentive to hoard and trade on inside information before revealing it to others.40

However, insider abstention does not interfere with internal communication. A manager who abstains from trading until private information is made public has no interest in delaying the release of the information to other managers within the firm. On the contrary, the manager would prefer to trade immediately, but accepts delay as the unavoidable cost of trading at the better, post-announcement price.

39 See Section 16(c) of the 1934 Act.
Thus, the manager has an incentive to transmit the information to others within the firm so that the information is made public as quickly as possible.\textsuperscript{41}

\textbf{d. Reduced Disclosure to Market}

Some commentators have argued insider trading could give managers an incentive to postpone disclosure of information to the market in order to give them time to trade on it.\textsuperscript{42} Indeed, managers might even have an incentive to disseminate rumors (or manipulate accounting earnings) in order to create price fluctuations on which they can profit.\textsuperscript{43}

Insider abstention has no such effects. A manager who abstains from trading until private information is made public has no incentive to hide the information from the market. Rather, he has an interest in seeing the information disclosed as quickly as possible, so that he can trade as quickly as possible. Thus insider abstention is unlikely to reduce the amount or slow the pace of disclosure to the market.

Nor does insider abstention, by itself, provide an incentive for managers to use misinformation to manipulate the stock price. Managers have no incentive to manipulate the stock price up or down unless the managers can either (a) sell when

\textsuperscript{40} 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).

\textsuperscript{41} One commentator has suggested that managers who are permitted to engage in insider trading will waste time spying on each other to learn inside information on which they can trade. See Dyer, supra note 31, at 21. Managers who can abstain on inside information might have similar incentives. However, if the managers can be prevented from trading while in possession of inside information, then \textit{ex ante} they have no incentive to spy on each other. For example, suppose that a manager is considering selling shares, and is curious whether there is some inside information suggesting that he should delay the sale. If he finds out that there is undisclosed good news, he can profit by delaying his sale until the news is released. If, however, he finds out that there is undisclosed bad news, he must hold onto his shares until the bad news is released, and thereby will be forced to sell his shares for a lower price.

\textsuperscript{42} They may also have an incentive to delay implementation of a project which will be disclosed as soon as the firm begins to implement it (e.g., layoffs) in order to trade in advance of that disclosure. See Dyer, supra note 31, at 21.

they know the stock is worth less than its market price or (b) buy when they know
the stock is worth more than its market price. But both of these transactions involve
trading while in possession of inside information (namely, that the stock is not
actually worth what the misinformation suggests). If managers can use inside
information only to abstain from trading, they cannot trade after they have distorted
the price, and accordingly they have no reason to distort the price in the first
instance.

e. Incentive to Choose Asymmetric-Information Projects

Finally, managers who can trade on inside information might have an
incentive to choose projects whose value will be difficult for the market to assess for
some time even if they generate less value than projects whose choice does not
create an information asymmetry. Insider abstention does not create a similar
incentive. As noted earlier, a manager who abstains from trading until her private
information becomes reflected in the stock price has an incentive to disclose the
information as quickly as possible in order to reduce the trading delay. Such a
manager will thus have an incentive to choose projects whose values can be assessed
easily by the market.

2. The Potentially Adverse Effect of Insider Abstention on the Cost of
Capital

Opponents of insider trading have also argued that insider trading increases
the cost of equity capital. Insider trading profits reduce – dollar-for-dollar – the
profits of other stockholders. To the extent that there is insider trading, investors
will anticipate lower returns from investing in stock and thus will not be willing to
pay as much for it.

44 See Dyer, supra note 31, at 21.
45 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); Brudney,
supra note 9, at 489 (same).
46 See Seyhun, supra note 26, at 190; WILLIAM K.S. WANG & MARC I. STEINBERG, INSIDER
Abstaining on inside information also reduces public shareholders’ returns, by enabling the insider to avoid an unfavorable trade that would otherwise transfer value to them. However, an insider prevented from trading while in possession of inside information will not be able to engage in a favorable trade that otherwise would 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 while aware of 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 increased above the market rate of return – the return they would enjoy if insiders did not trade at all.47

B. The Efficiency Benefits of Insider Abstention

Section A explained that the efficiency objections to insider trading – namely that insider trading distorts managers’ incentives and increases the cost of capital – largely do not apply to insider abstention. This Section explains why insider abstention is in fact likely to improve managers’ incentives and, therefore, likely to be desirable economically.

Insider abstention is likely to improve managers’ incentives by enabling managers to trade at prices that better reflect the actual value of their firms’ shares. For example, suppose that a CEO generates value for shareholders by increasing the firm’s earnings. Suppose further that the CEO is planning to sell shares, and would

47 If taxing corporate insiders to increase the returns of public shareholders were considered desirable, there would be much easier ways of implementing such a transfer 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. See Salbu, supra note ___ at 340-41. 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 determined) to the corporation.

Second, corporate insiders always could 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.
like to sell at a price that reflects the increased earnings. However, there is a delay
between when the CEO learns of the increased earnings and when these increased
earnings will be announced to the market.

If the CEO could not abstain on inside information, he would be forced to sell
his shares at a price that does not reflect their actual value, and he would be unable
to capture any of the benefit of the value that he helped create. As a result, he
would have less incentive to create that value in the first instance. If the CEO can
abstain until the information about the earnings is released to the market, he is able
to capture some of the benefit of the value he helped create, and thus has more of an
incentive \textit{ex ante} to create that value.

\section*{V. Policy Implications}

This Part examines three implications for the regulation of insider trading of
the distributional and efficiency analyses of insider abstention provided in Parts III
and IV. Section A discusses the first implication of the analysis: that insider
abstention does not, as some commentators have argued, represent a “loophole” in
the regulatory system that should, if possible, be closed. Section B addresses the
second implication: that – if parity between insiders and public shareholders is the
proper goal of insider trading regulation – the SEC’s “possession” interpretation of
Rule 10b-5 is superior to the “use” interpretation, because the “use” interpretation
permits insiders to trade and abstain while in possession of inside information,
while the “possession” interpretation permits insiders to abstain while in possession
of inside information, but not to trade. Section C examines Rule 10b5-1(c), the
SEC’s regulation that creates a safe harbor from Rule 10b-5 liability for insiders
selling shares according to a pre-arranged plan. It explains that, under the SEC’s
interpretation of Rule 10b5-1(c), insiders are permitted to both trade and abstain
while aware of inside information. It then explains how the Rule can be interpreted
to promote greater parity between insiders and public shareholders.

\section*{A. The Potential Effectiveness of Insider Trading Regulation}

The analysis offered in Parts III and IV has 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 certain pro-
regulation commentators have argued) as an undesirable “loophole” that needs to be closed or (as certain anti-regulation commentators have argued) as an embarrassing gap that makes clear the futility of insider trading regulation.

At least one pro-regulation commentator has considered various ways by which insiders might be prevented from abstaining based on inside information. As we have seen, however, if insiders are prevented from trading while in possession of inside information, parity does not require that insider abstention be prohibited. On the contrary: parity requires that insider abstention be permitted. In addition, the ability of insiders to use inside information to abstain is likely to be economically desirable. Thus, there is no reason to invest resources in determining how to prevent insiders from using inside information to abstain from trading.

On the other side of the debate, those critical of insider trading regulation, such as Henry Manne, have pointed to insider abstention as evidence that regulating insider trading is hopeless. The analysis offered in Part III, however, shows that one can obtain parity between insiders and outsiders “simply” by preventing insiders from trading while aware of inside information.

B. The “Use vs. Possession” Debate Under Rule 10b-5

The analysis offered can shed light on the “use vs. possession” debate under Rule 10b-5, a debate involving the SEC, the courts, and various commentators. In particular, the analysis suggests that to the extent lawmakers and regulators wish to

48 See e.g., Salbu, supra note __, at 340-342 (suggesting various ways of proving “fraudulent abstention”).

49 Alternatively, one could permit insiders to trade while in possession of inside information if the trade is pursuant to a pre-arranged plan, but not permit them to cancel a pre-arranged trade while in possession of inside information (see Section C infra).

achieve parity between insiders and public shareholders, the possession standard is preferable.

The “use vs. possession” debate concerns the mental state needed to trigger a violation of Rule 10b-5. For there to be liability, is it sufficient that the insider 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 trade? Suppose, for example, that the CEO of ABC Corporation decides on Monday morning, when the stock is trading at $10, to sell 1000 shares of his firm’s stock on Monday afternoon. Shortly before selling the shares on Monday afternoon, the CEO learns that earnings will be much worse than expected and that this information, which is expected to emerge on Tuesday, is likely to depress the stock price to $8. The CEO goes forward with his plan to sell 1000 shares of his stock at $10 each. On Tuesday, 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, mere possession of inside information while trading is sufficient to give rise to a violation of Rule 10b-5. According to the 9th and 11th Circuits, mere possession is not sufficient for Rule 10b-5 liability: instead, the SEC must demonstrate that the insider used the information in making the decision to trade, although the courts have concluded that proof of possession gives rise to a strong inference of use.

Participants in the debate have advanced a number of policy rationales in favor of each approach. In defense of the possession standard, the SEC and others have offered a number of arguments. First, the term “use” 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? Second,

51 See United States v. Teicher, 987 F.2d 112, 120 (2nd Cir. 1993).
52 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 CAL. CORP. CODE § 25402.
53 See United States v. Adler, 137 F.3d 1325 (11th Cir. 1998); United States v. Smith, 155 F.3d 1325 (9th Cir 1998).
54 See Id. at 1340.
55 Participants in the debate have also advanced doctrinal arguments in favor of each approach, which I will not repeat here.
56 See Teicher, 987 F.2d at 120; Schoen, supra note 48, at 281-2.
however “use” is defined, it would be extremely difficult to prove.\textsuperscript{57} On the other side, proponents of the “use” standard argue that the “possession” standard is unfair because it penalizes traders who might lack intent to defraud.\textsuperscript{58}

As Part III explained, insiders’ use of inside information to abstain from trading compensates them for their inability to effect intended trades when they are aware of inside information suggesting that the trade would be favorable. The net result is that they are no better off than public shareholders. However, the managers’ inability to trade while in possession of inside information depends on the use of a possession standard. If a use standard were in effect, managers would be permitted to trade while in possession of inside information indicating that the trade is favorable – at least in those cases where the managers are not considered to “use” the information to trade. To the extent that managers are free to trade while in possession of such information, their ability to abstain on inside information is not balanced by an offsetting disability, and the playing field tilts in favor of the managers. Thus, given that managers can abstain on inside information, parity (if that is desired) requires the use of a possession standard.

**C. SEC Rule 10b5-1**

As indicated in Part V.B, 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. The SEC has formally codified this position in Rule 10b5-1.

Rule 10b5-1(a) sets forth a definition of illegal insider trading under Section 10(b) of the 1934 Act and Rule 10b-5:

[T]he 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.

\textsuperscript{57} See Schoen, \textit{supra} note 48, at 279-280.

\textsuperscript{58} See Jolly, \textit{supra} note 48, at 249-250.
Rule 10b5-1(b) defines “on the basis of” as follows:

[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 does not make them better off than public shareholders. Thus, Rule 10b5-1(a) and (b) help level the playing field between insiders and public shareholders.

Rule 10b5-1(c)(1) then provides an “affirmative defense” to liability. 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

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59 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).
(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 essence, Rule 10b5-1(c)(1) allows an insider to purchase or sell while aware of material nonpublic information if they are “locked in” to the trade before they become aware of that information.60

If the insider were truly locked in to the trade, then this affirmative defense to insider trading liability would not provide the insider 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 sell while aware of bad news, but could not abstain while aware of good news. The insiders’ trades therefore would look exactly like the trades of a similarly situated public shareholder intending to sell shares who is unaware that there is any material nonpublic information bearing on the value of the shares.61

However, in June 2001, the SEC Division of Corporate Finance issued an “interpretation” of the operation of Rule 10b5-1(c) that tilts the playing field back in favor of insiders. In particular, the SEC indicated that terminating a trading plan

60 The SEC can overcome this affirmative defense by showing that the program was entered into in bad faith or as part of a scheme to evade Rule 10b-5. See Exchange Act Release No. 33-7881 § III.A.1 (Aug. 15, 2000).

61 One could call such a “lock-in” plan a “no-abstain/trade” regime because the insiders’ trade would take place even if he were in possession of information indicating that the trade is favorable, and it could not be cancelled if he becomes aware of information indicating that the trade is unfavorable. Note that such a regime is the exact opposite of that in which an insider has discretion to trade, subject to Rule 10b-5’s prohibition against trading while in possession of inside information. In the latter, which can be labeled an “abstain/no-trade” regime, the insider cannot trade while in possession of inside information indicating that the trade is favorable but can abstain from a trade while in possession of inside information indicating that the trade is unfavorable. However, under both regimes, the insider is no better off than a similarly situated public shareholder.
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. Lawyers suggest insiders can reduce the risk of a bad faith finding by expressly stating 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).

If parity is desirable, this interpretation is problematic. 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, the 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, if parity is desired, there seems to be little cost (in terms of inconvenience to insiders) to requiring that insiders wishing to avail themselves of the Rule 10b5-1(c) affirmative defense wait until they are unaware of 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

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62 See Q&A 15 under the heading “Rule 10b5-1(c)” at the SEC’s website www.sec.gov.
64 See, e.g., Cassell Bryan-Low, Stock Selling Plans Can Be Ended, But Could be Harder to Reinstate, WALL ST. J., March 6, 2002, at C18 (reporting that executives who have halted pre-arranged selling because they believe the price is too low are being advised by their lawyers to wait before reinstating the plan). Boris Feldman, Stock Trading Plans under Rule 10b5 -1 - - - FAQs, 5 CYBERSPACE LAWYER 19 (2000) (advising that the termination of a plan followed by the subsequent adoption of a new plan could undermine the value of the defense).
constant flow of shares). Therefore, most plans would involve selling small amounts of shares on a regular basis. Accordingly, there should be few liquidity or diversification costs to preventing insiders from halting their trades for the period of time in which they have information indicating the trades are unfavorable. If the cost of requiring insiders to wait until they have no inside information before canceling their plans is indeed low, and if parity is desired, such a waiting requirement might be worth adopting. Interestingly, at least one firm has voluntarily adopted such a requirement.

 VI. Conclusion

Although Rule 10b-5 prohibits insiders from trading on inside information, insiders are not prohibited from using inside information to abstain from trading. Because of this “abstention problem,” legal commentators – both those opposed to Rule 10b-5 and those in favor of it – have concluded that insiders prevented from trading on inside information still retain an ability to earn abnormal returns in their trading.

This paper has shown, using a simple model, that the conventional wisdom is wrong: insiders prevented from trading while in possession of inside information are not better off than public shareholders, even if they can use such information to abstain from trading. In fact, if insiders could neither trade nor abstain while in possession of inside information, they would systematically make lower trading profits than public shareholders.

The paper also considered the efficiency effects of insider abstention – including its effect on managerial incentives and the cost of capital. It showed that even if, as many believe, insider trading distorts managers’ incentives and raises the cost of capital, insider abstention does not. Indeed, insider abstention aligns

\[65\] As discussed in Part IV.B., 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 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.

\[66\] See Cassell Bryan-Low, supra note 62.
managers’ interests with those of shareholders as a group, and is therefore beneficial.

The paper’s analysis has a number of implications for insider trading regulation. First, achieving parity between insiders and public shareholders does not require – as both supporters and opponents of insider trading regulation have argued – preventing insider abstention. Second, the analysis suggests that if regulators and courts wish to achieve parity between insiders and outsiders they should apply a “possession” rather than a “use” standard to insider trading. Third, if parity-seeking regulators wish to permit insiders to buy or sell shares pursuant to pre-arranged trading plans to trade while in possession of inside information, the regulators should not permit the insiders to cancel planned trades while in possession of inside information. I hope that the analysis provided here will be useful to the designers and interpreters of insider trading regulations.