Why Legalized Insider Trading Would Be a Disaster

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ABSTRACT

Although insider trading is illegal, a stubborn minority still defends it as an efficient means of compensating executives and spurring innovation. However, this minority assumes that legal insider trading would be constrained by the personal wealth of the insiders so that the scope of insider trading would rarely or never be so large as to cause outsiders to stop trading in affected stocks. This Note argues that there would be no such constraint because insiders could obtain outside financing to fully exploit their informational advantage. Outsiders would flee the public stock markets, which would drastically shrink or disappear. The prospect of huge trading profits would induce managers to change many decisions, often to the detriment of the firm, in ways that would be virtually impossible for corporate monitors to detect. Accordingly, the case of legalizing insider trading is insupportable.

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Although insider trading is illegal and widely condemned, a stubborn minority still defends it as an efficient method of compensating executives and spurring innovation.[1] However, these defenses crucially assume that the wealth of individual insiders constrains the scope of insider trading.[2] Accordingly, this minority argues that the abnormal profits realized by inside traders, at the expense of outsiders, are rarely or never large enough to cause outsiders to flee the affected stock.[3] Similarly, the potential gains from insider trading are rarely, if ever, big enough to corrupt the managers' business conduct.[4] Thus, insider trading generates benefits for stockholders that exceed its immediate losses.[5]

This Note opines that, if insider trading were allowed, it would not be constrained by insiders' wealth, because insiders could obtain enough outside financing to fully exploit their informational advantage. In so doing, insiders would inevitably "muscle out" public investors.[6] Stock markets would drastically shrink, if not disappear.[7] The prospect of huge trading profits would tempt managers to alter many decisions, causing damage to the firm in ways that would be virtually impossible for corporate monitors to detect.[8] The resulting damage to public shareholders would far exceed any benefits from insider trading.[9] Accordingly, the case for insider trading is insupportable.[10]

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[1]A number of state courts continue to hold that insider trading breaches no fiduciary duty. *See* STEPHEN M. BAINBRIDGE, CORPORATION LAW AND ECONOMICS 572 n.58 (2002); *see also* HENRY MANNE, INSIDER TRADING AND THE STOCK MARKET 172-73, 178 (1966) (categorizing the perceived danger posed by insider trading as generally exaggerated and noting how businesses may actually benefit from the use of inside information by government officials); Dennis W. Carlton & Daniel R. Fischel, *The Regulation of Insider Trading*, 35 STAN. L. REV. 857, 860 (1983) (arguing that insider trading is, in many markets, irregularly enforced, and that the law, in promoting enforcement, ignores the economic realities of insider trading); Darren T. Roulstone, *The Relation Between Insider-Trading Restrictions and Executive Compensation*, 41 J. ACCT. RESEARCH 525, 549 (2003) ("[I]nsider trading rewards and motivates executives.").

[2]*See* BAINBRIDGE, *supra* note 1, at 591 ("[T]he insider's compensation is limited by the number of shares he can purchase. This, in turn, is limited by his wealth."); *see also* MANNE, *supra* note 1, at 173 (discussing the parameters of inside information usage by government employees).

[3]*See infra* Part II (describing how insider trading, due to the fact that it is illegal, does not involve utilization of loaned funds).

[4]*See* Carlton & Fischel, *supra* note 1, at 873-76 (arguing that critics of insider trading exaggerate its supposedly perverse incentives).

[5]*See infra* Part I (summarizing the general arguments made by those who support insider trading).

[6]*See infra* Part II.

[7]*See infra* Part II.

[8]*See infra* Part III.

[9]*See* BAINBRIDGE, *supra* note 1, at 598 ("In short, the federal insider trading

I. THE CASE FOR INSIDER TRADING

Proponents of insider trading cite its ability to generate substantial benefits without causing substantial damage.[11] The primary alleged benefit is that, in some situations, insider trading profits are the best way to compensate executives and induce innovation.[12] Henry Manne initiated this argument.[13]

> [A]n entrepreneur's contribution to the firm consists of producing new valuable information. The entrepreneur's compensation must have a reasonable relation to the value of his contribution to give him incentives to produce more information. Because it is rarely possible to ascertain information's value to the firm in advance, predetermined compensation, such as salary, is inappropriate for entrepreneurs. Instead, claimed Manne, insider trading is an effective way to compensate entrepreneurs for innovations.[14]

This is not what happens now.[15] Today, employees who have *not* created the valuable information conduct most insider trading.[16] The use of insider trading as a reward for innovation would require each public company to designate who would be allowed to make such trades, and

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prohibition is justifiable solely as a means of protecting rights in information.").

[10] *See infra* Part VI.

[11] MANNE, *supra* note 1, at 154-56 (describing variables that influence the market, irrespective of whether trades are executed via inside knowledge).

[12] *See id.* at 155 ("Therefore, the additional compensation provided by insider trading [to executives]…also benefits the corporation.").

[13] *See id.* at 155.

[14] BAINBRIDGE, *supra* note 1, at 590. *See also id*. at 604 ("The only plausible justification . . . is the argument that legalized insider trading would be an appropriate compensation scheme.").

[15] *See* Robert A. Prentice & Dain C. Donelson, *Insider Trading as a Signaling Device*, 47 AM. BUS. L.J. 1, 4 (2010) (describing how the promotion of insider trading is a problematic idea and therefore policy choice).

[16] *See id.*; SEC v. Maxwell, 341 F. Supp. 2d 941, 944 (S.D. Ohio 2004); SEC v. Switzer, 590 F. Supp. 756, 761-63 (W.D. Okla. 1984); *see also* John P. Anderson, *Greed, Envy, and the Criminalization of Insider Trading* 30 (Miss. Coll. Sch. of Law Research, Paper No. 2012-03, 2012), *available at* http://ssrn.com/sol3/papers.cfm?abstract_id=2148688 ("[Some trade on inside information is acquired] by shear [sic] luck or by eavesdropping on the conversation of insiders.").

when they could occur, to monitor compliance.[17] This raises huge logistical problems.[18]

The second supposed benefit of insider trading is that it enhances the accuracy of prices in the stock market.[19] Even if this were true, it is doubtful that it generates much benefit.[20] Even in the absence of insider trading, the market for frequently traded securities is already quite efficient.[21] Any benefit from the additional accuracy caused by insider trading would probably be trivial.[22] More important, insider trading also impairs the functioning of securities markets.[23]

As for the alleged detriments of insider trading, its defenders claim that its scope is constrained by the wealth of individual insiders.[24] Accordingly, although the abnormal profits realized by inside traders must (at the moment) come at the expense of outsiders, the cost to the latter will be small enough that outsiders will not abandon trading in the firm's stock.[25] Edward Herman—pointing to the widespread public stock ownership and active trading in the 1920s, when insider trading was not

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[17]*See* Prentice & Donelson, *supra* note 15, at 4-5 (citations omitted) ("[I]nsider trading cannot be limited to the employee who created the information.").

[18]*See infra* Part V.

[19]*See* WILLIAM K. S. WANG & MARC I. STEINBERG, INSIDER TRADING 19 (3d ed. 2010) ("Increased accuracy of securities prices may also improve capital allocation . . . [and] may enhance the efficiency of the market by moving prices in the correct direction.").

[20]The supposed benefit of accurate securities prices is that they help to direct capital to the most profitable uses; however, "[r]esource allocation is not directly affected by trades of existing securities." WANG & STEINBERG, *supra* note 19, at 23.

[21]*See* BAINBRIDGE, *supra* note 1, at 115 ("The [efficient capital markets hypothesis] is widely regarded as one of the most well-established propositions in the social sciences."); BURTON G. MALKIEL, A RANDOM WALK DOWN WALL STREET 246 (9th ed. 2007) ("Above all, [many economists] believe that financial markets are efficient because they don't allow investors to earn above-average returns without accepting above average risks."); Ronald J. Gilson & Reiner H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 549-53 (1984) (speculating about the various reasons for market efficiency).

[22]MALKIEL, *supra* note 21, at 246 (describing numerous factors, not including insider trading, to which economists attribute market efficiency).

[23]*See infra* Part IV.

[24]*See supra* note 2 and accompanying text.

[25]*See* BAINBRIDGE, *supra* note 1, at 594 n.23 ("[A]ny gains siphoned off by insiders with respect to a particular stock are likely to be an immaterial percentage of the gains contemporaneously earned by the class of investors as a whole."); *see also id*. at 596 ("In the absence of a credible investor injury story, it is difficult to see why insider trading should undermine investor confidence in the integrity of the securities markets."); Anderson, *supra* note 16, at 7 ("[M]ost economists now agree that the direct impact of insider trading on counterparties is either non-existent or indeterminable."); Robert E. Wagner, *Gordon Gekko to the Rescue? Insider Trading as a Tool to Combat Accounting Fraud*, 79 U. CIN. L. REV. 973, 998-1005 (2011) (arguing that legalized insider trading would not undermine investors' willingness to trade in the stock markets).

clearly illegal—argues that insider trading would not deter outsider trading.[26] Stock markets, however, have changed since the 1920s.[27]

More important, even in the 1920s the legality of insider trading was far from clear.[28] The so-called "majority rule" allowed insider trading.[29] However, this rule was subject to an exception whenever "special facts" existed.[30] "Since there was no meaningful way to differentiate those cases that involved 'special facts' from those that didn't, the special-facts exception either ate up the majority rule or made the rule impossible to administer in a consistent fashion."[31] Clearly, legalizing insider trading would be very different, and have very different consequences.[32]

II. THE EFFECT OF OUTSIDE FINANCING ON INSIDER TRADING

If insider trading were simply permitted without any restriction, insiders would be free to seek outside financing for their trading.[33] The incentive for them to do so is obvious.[34] Outsiders already borrow

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[26]Edward S. Herman, *Equity Funding, Inside Information, and the Regulators*, 21 UCLA L. REV. 1, 17 (1973) ("Perhaps this form of fraud is not regarded seriously because the market is so full of arbitrary advantage . . . [and] privilege."). In a similar vein, Stephen Bainbridge says: "The loss of confidence argument is further undercut by the stock market's performance since the insider trading scandals of the mid-1980s. The enormous publicity given those scandals put all investors on notice that insider trading is a common securities violation." BAINBRIDGE, *supra* note 1, at 596.

However, Congress then strengthened the laws against insider trading and the SEC stepped up enforcement actions against inside traders. *See* Insider Trading and Securities Fraud Enforcement Act of 1988, Pub. L. No. 100-704, 102 Stat. 4677 (1988) ("[N]onetheless, additional methods are appropriate to deter and prosecute violations of such rules and regulations."); Insider Trading Sanctions Act of 1984, Pub. L. No. 98-376, 98 Stat. 1264 (1984) (increasing, *inter alia*, the penalties associated with insider trading). This may have reassured investors that insider trading would be substantially mitigated. Moreover, these scandals occurred at the beginning of a prolonged economic expansion, which probably overwhelmed any increased investor concerns about insider trading.

[27]*See infra* Part IV.

[28]*See* MELVIN ARON EISENBERG & JAMES D. COX, CORPORATIONS AND OTHER BUSINESS ORGANIZATIONS: CASES AND MATERIAL 943 (10th ed. 2011).

[29]*Id.*

[30]Strong v. Repide, 213 U.S. 419, 433 (1909) (analyzing the facts of the transactions in question with the goal of determining legality).

[31]EISENBERG & COX, *supra* note 28, at 946.

[32]*See infra* Part IV.

[33]*See* THOMAS LEE HAZEN, THE LAW OF SECURITIES REGULATION § 14.9[1], at 794 (4th ed. 2002) ("A large number of securities transactions, especially those by speculative investors, are entered into by the broker extending credit to the purchaser.").

[34]*Id.*

money for stock trading "on margin," so, logically, insiders could borrow in a similar fashion.[35]

Indeed, insiders would have both the will and the means to borrow much more heavily than outsiders.[36] In an efficient securities market, few outsiders, if any, can consistently beat the market.[37] Even if a handful of outsiders can regularly outperform the market, lenders cannot easily identify them.[38] Accordingly, lenders must treat borrowers as "noise" traders who assume all the risks of the market's volatility.[39] To insulate themselves from these risks, lenders must limit the loans they make, and either monitor the borrower's performance to make a margin call when the value of the borrower's securities falls near the amount of the loan, or demand security from a pledge of other assets owned by the borrower.[40]

Insiders, however, can consistently beat the market; they already do.[41] Since their trading is less risky than outsider trading, lenders would

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[35]*See* HAZEN, *supra* note 33, at 794 ("[Purchasing] 'on margin' [is where] the broker advanc[es] part of the purchase price to the customer.").

[36]*See* WANG & STEINBERG, *supra* note 19, at 19 (describing the limitations insider trading laws place on resource allocation to such traders).

[37]*See id.* at 26 ("[E]ven the most sophisticated institutions have difficulty outperforming the stock market averages."); STEPHEN A. ROSS, RANDOLPH W. WESTERFIELD & JEFFREY F. JAFFE, CORPORATE FINANCE 353 (6th ed. 2006), *quoted in* ROBERTA ROMANO, FOUNDATIONS OF CORPORATE LAW 63 (2d ed. 2010) ("The overwhelming evidence . . . is that mutual funds, on average, do not beat broad-based indices.").

[38]*See* MALKIEL, *supra* note 21, at 246 ("$100 bills are not lying around for the taking, either by the professional or the amateur investor.").

[39]*Noise Trader Definition*, INVESTOPEDIA.COM, http://www.investopedia.com/terms/n/noisetrader.asp (last visited Feb. 20, 2013) ("[Noise Trader is] [t]he term used to describe an investor who makes decisions regarding buy and sell trades without the use of fundamental data. These investors generally have poor timing, follow trends, and over-react to good and bad news.").

[40]*See* HAZEN, *supra* note 33, § 14.9[1], at 795-97 (explaining margin maintenance and margin calls).

[41]*See* Joseph E. Finnerty, *Insiders and Market Efficiency*, 31 J. FIN. 1141, 1148 (1992) (noting that even critics agree that insiders are capable of outperforming the market); Dan Givoly & Dan Palmon, *Insider Trading and the Exploitation of Inside Information: Some Empirical Evidence*, 58 J. BUS. 69, 76 (1985) (noting that insiders generate impressive and abnormal results); Jeffrey F. Jaffe, *Special Information and Insider Trading*, 47 J. BUS. 410, 424 (1974) (explaining the results of a study finding that insiders realize significant abnormal returns); Susan Pulliam & Rob Barry, *Executives' Good Luck in Trading Own Stock*, WALL ST. J., Nov. 28, 2012, at 1 (explaining that statistics show that executives who trade irregularly perform better in the market than those who trade in an annual pattern).

Of course, insiders can make mistakes. They might, for instance, overestimate the market's reaction to some development and by their trading push the price farther than the market deems appropriate after the development is disclosed. However, insiders are better positioned than outsiders to evaluate new information, and they can be cautious in their be willing to lend them more money.[42] Furthermore, because their trading poses little risk, insiders would be more willing to give personal assets (like their homes) as collateral to secure loans than would prudent outsiders.[43] As a result, borrowing could greatly multiply the trading capacity of insiders.[44]

Alternatively, an insider could also obtain equity financing by forming a company ("insider trading equity fund" or "ITEF") to implement her trades and inviting investors to buy stock in her fund. Although it is theoretically possible for outside investors to get equity financing,[45] it would generally be foolish for others to provide such financing because few, if any, outsiders can consistently beat the market.[46] Any investor can guess, so giving money to another investor who is also guessing does not generate better returns.[47] Mutual funds offer investors an easy way to obtain and maintain diversification, and they handle the paperwork that investors would otherwise have to do themselves,[48] but they do not outperform the market.[49]

Since insiders will often outperform the market, they could offer investors better returns than are otherwise available to them.[50] As such, insiders should be able to raise as much equity financing as they could profitably deploy, but in reality such equity financing is unnecessary. Entrepreneurs typically issue equity only when an investment is risky;[51]

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trading, so such mistakes should be rare. *See* Roland Benabou & Guy Laroque, *Using Privileged Information to Manipulate Markets: Insiders, Gurus, and Credibility*, 107 Q.J. ECON. 921, 924 (1992).

[42] *See, e.g.*, MANNE, *supra* note 1, at 60 (noting that there is less uncertainty and risk associated with insider trading because when insiders purchase shares, the value of all shares rise).

[43] *Id.*

[44] To secure loans ready when needed, insiders could arrange lines of credit in advance with lenders. Insiders could also trade on options, which are much cheaper than the underlying stock, thereby further leveraging their trading capacity. *See* EISENBERG & COX, *supra* note 28, at 777.

[45] *See* Mark A. Allebach, *Small Business, Equity Financing, and the Internet: The Evolution of a Solution?*, 4 VA. J.L. & TECH. 3, 21-31 (1999) (describing desirable conditions to obtain equity financing without explicitly excluding outside investors).

[46] *See* MALKIEL, *supra* note 21, at 210 ("[A]ll investors . . . are risk-averse."); *supra* note 36 and accompanying text.

[47] *See* MALKIEL, *supra* note 21, at 204 ("Your guess is as good as that of the ape, your stockbroker, or even mine.").

[48] *Id.* at 372 ("In addition to offering risk reduction through diversification, the mutual funds provide freedom from having to select stocks, and relief from paperwork and record-keeping for tax purposes.").

[49] *See supra* note 37 and accompanying text.

[50] *See supra* note 41 and accompanying text.

[51] *See, e.g.*, Hunter C. Blum, *ESOP's Fables: Leveraged ESOPs and Their Effect on Managerial Slack, Employee Risk and Motivation in the Public Corporation*, 31 U. RICH. L.

debt is preferred for safer investments because it is cheaper.[52] Because insiders take little risk,[53] they arguably would be able to raise most or all the capital they can profitably use by borrowing.[54]

Does this projection underestimate the risks insiders may incur? The efficiency and rationality of stock markets have been questioned.[55] Limits to arbitrage may restrict the ability of traders to correct mispricing, so bubbles may persist.[56] The activity of uninformed (or "noise") traders may not be random and independent but may be herd-like behavior.[57] More generally, it is unclear how "rational" (or fundamental value efficient) stock markets are.[58]

It is hard to see, however, how these market defects pose much risk to inside traders, who typically trade on the basis of information that is expected to be publicly disclosed shortly after being attained by these inside traders.[59] Regardless of the possible market flaws just listed, it is widely accepted that markets react quickly—and appropriately—to the

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REV. 1539, 1545 (1997) ("[S]hareholders seek higher returns from equity than debt because their risk levels are higher.").

[52] *See* WILLIAM R. LASHER, PRACTICAL FINANCIAL MANAGEMENT 560 (2011) ("Generally the return on an equity investment is higher than the return on debt or preferred because the risk is higher. Hence, the firm's cost of equity capital is higher than its cost of debt or preferred stock. The return/cost of debt tends to be the lowest of the three, because debt is the least risky investment.").

[53] *See supra* note 42 and accompanying text.

[54] To the extent that equity funding was desirable, the funds would probably be private, because public offerings of stock are much more costly than private placements, and public investment companies are subject to extensive regulation. *See* BAINBRIDGE, *supra* note 1, at 87 ("[A] registered public offering is a very expensive proposition . . . [and] public offering easily can take months to complete.").

[55] *See* RONALD J. GILSON & BERNARD S. BLACK, THE LAW AND FINANCE OF CORPORATE ACQUISITIONS 138-39 (2d ed. 1995) (presenting evidence that stock markets are *not* fundamentally value efficient).

[56] *See* ROMANO, *supra* note 37, at 63-64 (explaining that limits to arbitrage may make it difficult to correct mispricing); *see also* MALKIEL, *supra* note 21, at 234, *as reprinted in* ROMANO, *supra* note 37, at 79-80 ("Arbitrageurs . . . are expected to take offsetting positions . . . so that any mispricing caused by irrational investors is quickly corrected.").

[57] *See generally* Stephen M. Bainbridge, *Mandatory Disclosure: A Behavioral Analysis*, 68 U. CIN. L. REV. 1023 (2000) (explaining that herd behavior is not random and occurs when an uninformed actor chooses to follow the decisions of a presumably better informed person).

[58] *See* ROMANO, *supra* note 37, at 85 ("[W]hether stocks are correctly valued . . . is impossible to measure."); *see also* GILSON & BLACK, *supra* note 55, at 138-39 (presenting evidence that stock markets are not fundamentally value efficient).

[59] Trading on the belief that a bubble exists would entail greater risks. However, insiders seem not to trade (at least not aggressively) on such beliefs. There is no evidence that insiders massively bailed out (much less made extensive short sales) during the high tech and housing market bubbles. *See* Frederick C. Dunbar & Dana Heller, *Fraud on the Market Meets Behavioral Finance*, 31 DEL. J. CORP. L. 455, 494 (2006) (discussing concerns pursuant to trading when bubbles exist).

release of news.[60] Theoretically, an insider buying (or selling) a stock based on non-public (either good or bad) news could get burned if a herd of irrational noise traders happened to send the stock's price down (or up), despite disclosure of the good (or bad) news.[61] Such incidents, however, must be extremely rare; I have not noticed reference to any such cases in the voluminous literature on insider trading. At most, market irrationality might somewhat limit the ability of insiders to borrow for trading, thus forcing them to raise a little more outside equity.[62]

Alternatively, insiders could sell their information.[63] An investment company could create a public "Tippee Trading Fund," and pay insiders for information on which the fund would then trade.[64] This would save insiders the time and expense of trading through their own accounts.[65]

Could this situation be avoided by allowing insider trading, but limiting it to the insider's personal funds?[66] Minimally, such a limitation would radically change the standards for executive hiring and retention. A more wealthy person could reap larger returns from insider trading than an individual with less personal capital, and therefore would need fewer alternate forms of compensation.[67] Indeed, some wealthy individuals might offer to pay a company for the privilege to engage in

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[60] *See* BAINBRIDGE, *supra* note 1, at 114 (explaining that professional investors react to new information by trading, and this moves stock prices in response to the change of information).

[61] *See, e.g.*, Charles K. Whitehead, *The Goldilocks Approach: Financial Risk and Staged Regulation*, 97 CORNELL L. REV. 1267, 1286 (2012) ("Noise trading increases . . . the risk that informed traders will lose money on arbitrage transactions.").

[62] *See* Margaret Bogenrief, *A Tale of Two Lending Markets*, J. CORP. RENEWAL, Apr. 20, 2011 (asserting that lending institutions are most interested in lending to profitable companies with the least amount of risk).

[63] *See* Donald C. Langevoort, *Investment Analysts and the Law of Insider Trading*, 76 VA. L. REV. 1023, 1052 (1990) (addressing the possibility of an insider selling his inside information).

[64] *See* BAINBRIDGE, *supra* note 1, at 564 (discussing circumstances under which the court will not find the tippee liable).

[65] Roberta Romano provocatively asks: "Could insiders profit by becoming market makers themselves and offering a lower spread?" ROMANO, *supra* note 37, at 665.

Without taking that step insiders could still contract to tip market makers, whose positions may enable them to exploit inside information more cheaply than anyone else can. *See supra* note 64 and accompanying text.

[66] *See* Benjamin Alaire, *Dividend Entitlements and Intermediate Default Rules*, 9 STAN. J.L. BUS. & FIN. 135, 170 (2004) (describing circumstances under which insiders could use personal funds to trade on nonpublic material).

[67] *Id.* at 170-71 (discussing the potential for insiders to earn virtually unlimited returns with enough funding).

insider trading of its stock.[68] An individual's managerial ability would still be a crucial factor, but among several talented managerial candidates, the lower salary demands of wealthier executives could be decisive.[69]

The fairness of such a limitation would be questionable, as it would allow wealthier executives to reap greater profits than the less wealthy.[70] Such a limitation would also be challenging to enforce and even to define.[71] Trading on public markets is at least observable, but private financing is not.[72] How would the SEC or anyone else know whether an insider had borrowed money (*e.g.*, from a friend or relative) with which to trade? How could one say whether an insider was using a home mortgage loan for purposes of insider trading? Insiders could also easily avoid the personal-wealth limitation by selling their inside information to tippees unless that behavior was also forbidden.[73]

To avoid these problems, the law could simply limit the amount of insider trading. Establishing and enforcing appropriate limits, however, would be difficult.[74] Even limited opportunities for insider trading would affect managerial conduct, as discussed in the next section.[75] Moreover, it is unnecessary to incur these problems because any beneficial incentives created by allowing limited insider trading can be better achieved through other forms of incentive compensation.[76]

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[68]*Id.* (noting the advantage that insiders have in the market over outsiders, attributable to their possession of nonpublic information).

[69]*See supra* note 67 and accompanying text.

[70]*Id.*

[71]*See* Kimberly D. Krawiec, *Fairness, Efficiency, and Insider Trading: Deconstructing the Coin of the Realm in the Information Age*, 95 NW. U. L. REV. 443, 449 (2001) (discussing means by which insiders could evade limitations on insider trading).

[72]*See* Carlton & Fischel, *supra* note 1, at 868 (explaining that insider trading is observable on the market).

[73]*See* Krawiec, *supra* note 71, at 499 ("Many insiders will . . . evade the . . . limitations on insider trading by trading through or tipping friends and family members.").

[74]*Inter alia*, it would be difficult to choose the criteria for the permitted amount of insider trading for each company. How would the amounts be set for each officer? For instance, what would be the optimal level of permissible insider trading by directors? Would insider trading allowances be tradable? *See id.* at 448.

[75]*See infra* Part III.

[76]*See* Kristoffel R. Grechenig, *The Marginal Incentive of Insider Trading: An Economic Reinterpretation of the Case Law*, 37 U. MEM. L. REV. 75, 123 (2006) (discussing compensation packages that are not based on insider trading).

III. THE IMPACT OF LEGAL INSIDER TRADING ON CORPORATE GOVERNANCE

Prior commentators have noted that the temptation of insider trading could drastically alter an executive's management decisions.[77] This is most obvious with respect to disclosure.[78] Consider a CEO who has just received some good news and some bad news, the two of equal significance. She could disclose both simultaneously, and the company's stock price would not move. There would be then no occasion for insider trading.

Alternatively, she could disclose the two items separately. She could first sell some stock (and/or make short sales), then disclose the bad news. After the stock's price falls in response, she would buy stock at the lower price. She would then release the good news and profit when the stock price reacts by rising. Of course, her gains would be matched by the losses of outsiders, who would have lost nothing if both news items had been revealed simultaneously.

Other effects on management are less obvious, but more serious. For example, each insider would have an incentive to withhold information from colleagues and the board of directors until she could fully exploit the insider trading potential of that information.[79] Such behavior could impair management's ability to make good decisions.[80]

Insiders would also have an incentive to release false or misleading information to take advantage of the duped outsiders by trading against them.[81] Releasing materially false or misleading statements violates federal securities laws, and presumably would continue to do so after the legalization of insider trading,[82] but liability

[77] *See, e.g.*, BAINBRIDGE, *supra* note 1, at 599-600 (describing the incentive of withholding information that insiders would realize, if insider trading were permitted).

[78] *Id.*

[79] *See id.* (discussing how permissive insider trading would promote deliberate withholding of information); Robert J. Haft, *The Effect of Insider Trading Rules on the Efficiency of the Large Corporation*, 80 MICH. L. REV. 1051, 1054-56 (1982) (explaining various scenarios in which the employee might be tempted to withhold information from the rest of the company).

[80] *See supra* note 77 and accompanying text.

[81] Haft, *supra* note 79, at 1055 ("[P]rofit-maximizing insiders, before transmitting information upward, might attempt to arrange loans to purchase or sell a greater amount of stock than their available resources would otherwise permit. Insiders might also convey the information to select corporate outsiders to whom they owe favors or from whom they expect future benefits.").

[82] *See, e.g.*, Janus Capital Grp., Inc. v. First Derivative Traders, Inc., 131 S. Ct. 2296, 2299 (2011) (opining over whether a mutual fund investment advisor was liable for a 10b-5

for this behavior has many conditions, and violations are often hard to prove.[83] Currently, occasions when insiders can benefit personally from issuing false statements are relatively rare because trading on inside information is illegal.[84] By greatly increasing the frequency of such occasions, the legalization of insider trading would substantially increase the dissemination of false or misleading information.[85]

Officers would also have an incentive to run a company so as to increase the volatility of its stock by increasing risk, even if the steps taken diminish the company's value.[86] There is little potential for insider trading profit in a stock that does not often rise or fall.[87] A stock that is volatile has greater insider trading opportunities than in one that is stable.[88] Indeed, managers could profit by short selling a company's stock, and then deliberately making bad decisions that cause its stock price to plummet.[89]

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violation, pursuant to the dissemination of false information).

[83]*See, e.g.*, *id.* at 2301-02 (recognizing, *inter alia*, liability under SEC rule 10b-5 is limited to the person who makes the public statement; it does not extend to one who provided false information to the speaker); Ernst & Ernst v. Hochfelder, 425 U.S. 185, 194 (1976) (finding the plaintiff must prove that the speaker was not merely negligent but *knew* that the statement was false).

[84]*See Janus*, 131 S. Ct. at 2302. Thus, an insider who traded after the release of materially false information would violate the securities laws if she knew the information was false or had any other material nonpublic information, even if she did not make the false statement.

[85]*See* Frank Easterbrook, *Insider Trading, Secret Agents, Evidentiary Privileges, and the Production of Information*, 1981 SUP. CT. REV. 309, 336 (1981) ("It is not possible for the firm's stock to trade at the optimal level while the firm keeps its information hidden; better for the firm to release the information itself at the appropriate time.").

[86]*See id.* at 332; Jesse M. Fried, *Insider Signaling and Insider Trading with Repurchase Tender Offers*, 67 U. CHI. L. REV. 421, 425 n.18 (2000) ("The prospect of insider trading profits can [,*inter alia*,] discourage managerial effort by enabling insiders to profit even if they generate bad news.").

[87]*See* Saul Levmore, *In Defense of the Regulation of Insider Trading*, 11 HARV. J.L. & PUB. POL'Y 101, 104-05 (1988) ("But if we assume for the sake of argument, as proponents of deregulation must, that insider trading is a stimulant that cannot be equaled by compensation tools that are currently legal, then it follows that insider trading is also dangerous, because the profit potential from a drop in security prices can motivate poor work or behavior by insiders that is disastrous to the interests of the firm.").

[88]*See* Easterbrook, *supra* note 85, at 332 ("The opportunity to gain from insider trading also may induce managers to increase the volatility of the firm's stock prices. They may select riskier projects than the shareholders would prefer, because if the risk pays off they can capture a portion of the gains in insider trading, and, if the project flops, the shareholders bear the loss.").

[89]*See* Levmore, *supra* note 87, at 104-05 ("[A]n insider will actually *cause* a loss so that a price decrease that he can profit from will occur.").

The principal defense of insider trading is that it is an efficient form of executive compensation.[90] All the foregoing considerations cast doubt on that defense.

IV. THE IMPACT OF LEGAL INSIDER TRADING ON STOCK MARKETS

In most cases it is difficult, if not impossible, to identify specific victims of insider trading.[91] It does not, however, follow that insider trading is benign.[92] To analogize, offenses such as polluting the environment or failing to pay one's taxes have nameless victims, yet the existence of harm is clear; so it is with insider trading.[93]

Even proponents of insider trading acknowledge that it causes greater disparities between bid and ask prices.[94] Further, the SEC has said that "economic studies have provided support for the view that insider trading reduces liquidity, increases volatility, and may increase the cost of capital."[95] Thus, insider trading impairs more than it enhances the efficient functioning of stock markets, even when it is illegal, and therefore not very common.[96]

Scholars claim that widespread insider trading did not prevent rapid growth of the stock market in the 1920s.[97] However, even at the time, insider trading was not clearly legal.[98] Moreover, both stock ownership and trading are much greater now than they were in the 1920s.[99]

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[90] *See supra* notes 11-14 and accompanying text.

[91] *See supra* note 25, *infra* note 176.

[92] *See* Levmore, *supra* note 87, at 105 (describing various forms of malfeasance the spectre of insider trading can bring to a going concern).

[93] *Id.* ("[D]eregulation threatens the economy with less information and with strategically bad behavior by insiders. These arguments, and the evolution toward regulation of insider trading in so many legal systems, create a strong presumption that must be overcome by those who would deregulate.").

[94] *See* WANG & STEINBERG, *supra* note 19, at 37 ("[S]pecialists and market-makers may be the victims of stock market insider trading (although they may sometimes pass the harm to others)."); Stanislav Dolgopolov, *Insider Trading and the Bid-Ask Spread: A Critical Evaluation of Adverse Selection in Market Making*, 33 CAP. U. L. REV. 83, 144-45 (2004) (discussing the pros and cons of increased regulation on insider trading). However, some studies show no correlation. *See id* at 147-48.

[95] Exchange Act Release No. 43154, 73 SEC Docket 3, [2000 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶¶ 86, 319 (Aug. 15, 2000).

[96] *Id.*

[97] *See supra* note 26 and accompanying text.

[98] *See supra* notes 30-31 and accompanying text.

[99] *See* Carlton & Fischel, *supra* note 1, at 860 n.16 (describing historical international trends in insider trading regulation).

The ban on insider trading probably has something to do with this:[100] Stock traders are more sophisticated now than in the 1920s.[101] Most traders then were individuals, many of whom were buying stock for the first time and knew little of the risks, including insider trading, until they were rudely educated by the 1929 stock market crash.[102] Today, most trading is done by institutions that are keenly aware of such risks.[103] Furthermore, in the 1920s, no foreign stock markets barred insider trading, so investors had no better alternative than the American markets.[104] Today, all developed countries ban insider trading.[105] If America were to legalize insider trading, investors would simply go elsewhere.[106]

Legalizing insider trading could effectively destroy public stock markets.[107] Defenders of insider trading claim that it does not harm outsiders.[108] Although it is virtually impossible to identify the victims of any particular act of insider trading, it is easy to see that it must hurt outside investors collectively.[109]

Imagine two publicly traded companies with identical operations. In one there is some significant amount of insider trading; in the other there is none. In the former, insiders siphon off some of the profits from the stock. Accordingly, outsiders must value its stock lower than the stock of the latter company.[110] Nonetheless, as long as the level of insider

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[100] *See* Stephen M. Bainbridge, *An Overview of Insider Trading Law and Policy: An Introduction to the Insider Trading Research Handbook* 35-36 (UCLA School of Law, Law & Econs. Research, Paper No. 12-15 2012), *available at* http://ssrn.com/abstract=2141457 (describing the expansion of trading volume in recent years).

[101] *See* United States v. O'Hagan, 521 U.S. 642, 676 (1997) (discussing how the SEC passed Rule 14e-3(a) to prevent sophisticated traders from trading on the basis of material, nonpublic information, and then escaping responsibility due to lack of proof).

[102] *See, e.g.*, Strong v. Repide, 213 U.S. 419, 526 (1909) (describing fraud in a pre-1929 market).

[103] *See* Bainbridge, *supra* note 100, at 14 (describing the development of Exchange Act §§ 16(b) and 10(b)).

[104] *Id.* at 21.

[105] *See infra* note 125 and accompanying text.

[106] *Id.*

[107] United States v. O'Hagan, 521 U.S. 642, 658 (1997) ("Investors likely would hesitate to venture their capital in a market where trading was based on misappropriated nonpublic information unchecked by law."). If that statement is true, it would seem also to apply *a fortiori* to trading by insiders of the issuer.

[108] *See supra* note 25 and accompanying text.

[109] *See* Wagner, *supra* note 25, at 999 ("[I]n the most recent insider trading Supreme Court case, *United States v. O'Hagan*, 'there is no mention of individual harm in specific transactions. Rather, the focus is on the harm from a decrease in public confidence in the market.'").

[110] *See* Morris Mendelson, *The Mechanics of Insider Trading Reconsidered*, 117 U.

trading stays low, the potential profits to outsiders are still high enough to attract them to purchase the stock at some price.[111]

This all changes once insider trading is permitted, as it is hard to see how there could be any other trading.[112] Insiders will trade whenever no higher returns are attainable from other investments (*e.g.*, real estate).[113] Imagine being asked to bid on a bag whose contents you do not know, but that are known to another bidder. The informed bidder will raise her bid unless and until you bid more than the bag's fair value. No reasonable person would enter such a contest.[114]

It is suggested that insider trading will not scare off outsiders because they "already disregard a large body of evidence indicating that even the most sophisticated institutions have difficulty outperforming the stock market averages. . . . These investors may be convinced that certain stocks will make them money; the occurrence of insider trading may have little effect on investment so motivated."[115] Not all "uninformed" traders, however, are so naive.[116] Even investors familiar with the efficient market hypothesis buy and sell stock when they want to make additional investments, disinvest, or better diversify their portfolios.[117]

As already noted, the public market in a stock can survive some level of insider trading.[118] To compensate for the gains siphoned off by

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PA. L. REV. 470, 477-78 (1969) (book review) (discussing insider trading as a mechanism of relative devaluation); William K. S. Wang, *Stock Market Insider Trading: Victims, Violators and Remedies-Including an Analogy to Fraud in the Sale of a Used Car with a Generic Defect*, 28 VILL. L. REV. 27, 29 (2000) (noting that if insiders make more profit, other investors must make less); *see also* Obeua S. Persons, *SEC's Insider Trading Enforcements and Target Firms*, 39 J. BUS. RES. 187, 189 (July 1997) (asserting that an announcement of insider trading enforcement action by the SEC is associated with a price decrease in the affected stock).

[111] *See* WANG & STEINBERG, *supra* note 19, at 52-54 (describing how low volume securities may escape apparent damage from the presence of insider trading).

[112] *See* JASON KELLY, THE NEATEST LITTLE GUIDE TO STOCK MARKET INVESTING 2-3 (2010) (emphasizing the importance of stock trading).

[113] *Id.*

[114] *See* George A. Akerlof, *The Market for Lemons: Quality Uncertainty and the Market Mechanism*, 84 Q. J. ECON. 488 (1970) (explaining that such a situation is a variation on a market for lemons. That is, uninformed outsider buyers must assume that the seller is an insider with undisclosed bad news and, accordingly, discount the price they are willing to pay. With the market price so depressed, insiders will not sell unless they do have undisclosed bad news.).

[115] WANG & STEINBERG, *supra* note 19, at 26.

[116] *See* Mendelson, *supra* note 110, at 475 (asserting that it is a fallacy to assume that only certain types of investors are risk-averse).

[117] *See* Easterbrook, *supra* note 85, at 336 ("People invest in stock because they anticipate return.").

[118] *See* Wagner, *supra* note 25, at 1001 ("[E]ven though the most widespread insider trading scandal in the history of Wall Street had just been revealed and was still being reported

insiders, the market will discount a stock's price to allow rational trading by outsiders.[119] In an efficient market, uninformed investors cannot beat the market, but neither will they underperform other outsiders, "even the most sophisticated institutions."[120] They will invest in stocks if the stock market outperforms other available investments.[121] In the long run, it does.[122]

If insider trading becomes rampant, however, the only trades left on the table for outsiders will be those that insiders have spurned because they offer a lower return than is available elsewhere.[123] Not even the most sophisticated mutual fund could match the performance of even a minimally skilled insider. In such a world only a fool would utilize anything but an insider trading equity fund to trade stock.[124]

Not even through examining foreign experience can we adequately tell how stock markets would fare under legalized insider trading because "all countries with developed capital markets limit insider trading to some extent."[125] However, the breadth and enforcement of the prohibitions vary, and stricter insider trading bans are associated with wider stock ownership, better stock price accuracy, and deeper market liquidity.[126] The corporate cost of equity declines significantly when a country forbids insider trading and actually enforces the law.[127]

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on, the stock market value increased by almost 25%.").

[119]Investors who trade in a futile effort to beat the market are still irrationally incurring the transaction costs of trading, but these are not very large.

[120]WANG & STEINBERG, *supra* note 19, at 26.

[121]*See* Carlton & Fischel, *supra* note 1, at 881 (arguing that even if this means that insider trading at low levels will not injure outsiders, it does not follow that low levels of insider trading are not inefficient).

[122]*See* KELLY, *supra* note 112, at 2-3 (documenting that returns in the stock market have exceeded returns to other investments over the past 75 years).

[123]*See* WANG & STEINBERG, *supra* note 19, at 27 ("This delay would extend the period during which public traders incur beneficial windfalls or fortuitous losses.").

[124]Curiously, some commentators acknowledge this fact but fail to draw the inevitable conclusions. Bainbridge, *supra* note 100, at 35-36 ("When trading with insiders, the market maker or specialist . . . will always be on the wrong side of the transaction."). However, he stops there, failing to realize that legalizing insider trading would therefore force even sophisticated players like specialists out of the stock markets, thereby devastating if not completely destroying them. Rather, he treats the ban on insider trading as a form of rents for specialists and market professionals. *See id.* at 35-37.

[125]Bainbridge, *supra* note 100, at 21.

[126]*See* Laura N. Beny, *Insider Trading Laws and Stock Markets Around the World: An Empirical Contribution to the Theoretical Law and Economics Debate*, 32 J. CORP. L. 237, 258-59, 261-62, 273-80 (2007) (highlighting the types of insider trading enforcement provisions that are found internationally).

[127]*See* Utpal Bhattacharya & Hazem Daouk, *The World Price of Insider Trading*, 57 J. FIN. 75, 104 (2002) ("[T]he establishment of insider trading laws–is not associated with a reduction in the cost of equity. It is the difficult part–the enforcement of insider trading laws–

Countries that more effectively bar insider trading have less volatile stock markets.[128] So it is no surprise that whenever the SEC announces enforcement actions involving insider trading, the price of the affected stock declines.[129]

All this evidence contradicts the market efficiency arguments for insider trading. Although less of the pie remains for outsiders if more of it is taken by inside traders, outsiders might still be better off if insider trading spurs innovation, thereby causing the pie to expand.[130] In that case however, companies in markets that allow insider trading should have a lower cost of capital, and revelations of possible insider trading in a company's stock should cause its stock price to rise.[131] The evidence just discussed demonstrates that the opposite is true.

Outsiders might be able to share in superior profits by investing in insider trading equity funds. However, as already suggested, insiders will probably have little need to create such funds because they will be able to finance most or all of their trading with (cheaper) debt.[132] Thus, everyone but insiders would abandon the stock market.[133]

As an obvious consequence, public trading in stocks would essentially cease.[134] Insiders can trade only if there are outsiders (including market makers)[135] with whom to trade. If outsiders pull out,

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that is associated with a reduction in the cost of equity in a country."); Robert A. Prentice, *The Inevitability of a Strong SEC*, 91 CORNELL L. REV. 775, 831 n.347 (2006) (asserting that this phenomenon conforms to theoretical predictions); *see also* Mendelson, *supra* note 110, at 477-78 (positing that companies with insider trading would have a higher cost of capital than companies without it).

[128] *See* Julan Du & Shang-Jin Wei, *Does Insider Trading Raise Market Volatility?*, 114 ECON. J. 916, 940 (2004). A recent study concludes that "more democratic political systems enacted and enforced insider trading laws earlier than less democratic or authoritarian political systems, controlling for wealth, financial development, legal origin, etc." Laura N. Beny, *The Political Economy of Insider Trading Laws and Enforcement: Law vs. Politics? International Evidence* 44 (U. of Mich. Law & Econ., Olin Working Paper No. 08-001, 2012), *available at* http://ssrn.com/abstract=304383.

[129] *See* Persons, *supra* note 110, at 188-89 ("The negative effects of these SECs enforcement's [*sic*] can be attributable to noncompliance with the securities laws of target firms. Because insider trading enforcement also involves the noncompliance with the securities laws, the enforcement is likely to have a negative effect on a target firm's stock value.").

[130] *See* Carlton & Fischel, *supra* note 1, at 881 n.80 (arguing that permitting insider trading would expand the pie).

[131] *Id.*

[132] *See supra* note 124 and accompanying text.

[133] *See* Carlton & Fischel, *supra* note 1, at 879 ("In order to induce trade [of stocks], something must prevent the uninformed from holding the 'market' and not trading.").

[134] *Id.*

[135] WANG & STEINBERG, *supra* note 19, at 67 n.84 ("[M]arket-makers are disproportionately harmed by insider trading [and, accordingly,] market-makers' bid-ask

there would be no stock market; there would be no publicly traded companies.[136]

It would not, however, be tenable to have all the equity of large firms owned by just a few insiders; that is why public ownership originally evolved. If public ownership were destroyed by insider trading, large firms would have to seek investment from private equity companies.[137] In most cases, private equity owners demand control.[138] As part of that control, they also insist on full disclosure when executives buy or sell the firm's stock.[139] In other words, they do not tolerate insider trading. Thus, ironically, legalizing insider trading would lead to the extinction of public stock markets and of insider trading itself.

Although unrestricted insider trading would destroy the stock markets and thus preclude insider trading, could market forces somehow react so as to prevent this destruction? It is true that individual insiders would have no incentive to restrain their trading,[140] but, as a response, individual companies could try to curb insider trading.[141]

V. CAN THE MARKET HANDLE INSIDER TRADING?

Public stock ownership evolved because it is efficient in many situations. The disappearance of public ownership posited in the preceding section would be inefficient, but markets tend to be efficient.[142]

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spreads are wider for firms with a great deal of insider trading."). *See also* MANNE, *supra* note 1, at 102 (arguing that frequent traders are more likely to be harmed by insider trading than long-term investors). If insider trading were legalized and became widespread, market-makers would probably have to cease doing business.

[136]Is this fear exaggerated? It has been pointed out that until recent legislation, government officials could trade on misappropriated nonpublic information, but this did not destroy the stock markets. However, even before the recent legislation, the legality of such trading was unclear. *Compare* Stephen M. Bainbridge, *Insider Trading Inside the Beltway*, 36 J. CORP. L. 281, 285 (2011) ("[C]ongressional staffers and other government officials and employees could be prosecuted successfully for insider trading under the federal securities laws, but the quirks of the relevant laws almost certainly would prevent members of Congress from being successfully prosecuted."), *with* Donna M. Nagy, *Insider Trading, Congressional Officials, and Duties of Enforcement*, 91 B.U. L. REV. 1105, 1142-43, 1147 (2011) (arguing to the contrary that politicians are also subject to political pressures against such behavior to which business executives are not exposed. As a result, the level of such misappropriation trading by government officials has been too low to destroy the stock markets.).

[137]*See supra* note 135 and accompanying text.

[138]*See supra* note 135 and accompanying text.

[139]*See supra* note 135 and accompanying text.

[140]*See supra* note 135 and accompanying text.

[141]*See* Carlton & Fischel, *supra* note 1, at 862-63 (stating that there has been little to no consideration regarding private regulation of insider trading).

[142]*See* Beny, *supra* note 128, at 2 ("Despite theoretical arguments that stock markets are more efficient when insiders are allowed to trade freely, many increasingly regard insider

Why, then, could the market itself not preserve public ownership to the extent that it is efficient? Insider trading apologists argue that corporations could have prohibited insider trading long ago, but they did not do so.[143] These apologists infer that such a prohibition would be inefficient.[144]

However, in the last thirty years, many corporations have adopted insider trading prohibitions.[145] Moreover, prior to that time many corporations did not even expressly prohibit embezzlement.[146] This does not mean these corporations condoned embezzlement. Rather, they probably believed that any employee caught stealing would be fired and become unemployable, and that any further sanction would be imposed by public law.[147] The same reasoning probably applied to insider trading.[148] Although many firms in the past (and some still today) do not formally forbid insider trading, never did any firms in the past publicly condone insider trading, and none have sought exemptions from the laws against insider trading.[149]

Thomas Lambert proposes that corporations be allowed to opt out of insider trading laws, so long as insiders disclose their identities and the fact of their trading at the time of their trades.[150] This arrangement would cause serious uncertainty whenever such an insider traded.[151] Insiders may trade not to exploit non-public information, but simply because they need cash or have extra cash that they want to invest.

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trading as a threat to stock market integrity and efficiency.").

[143] *See* Carlton & Fischel, *supra* note 1, at 864 (discussing the issues surrounding the prospect of company-based contractual limitations on insider trading).

[144] *Id.* at 863-64.

[145] *See* WANG & STEINBERG, *supra* note 19, at 35. One reason for the change may be "the enhanced pressure from congressional legislation enacted in the 1980s." *Id*. *See also* J. C. Bettis, J. L. Coles & M.L. Lemmon, *Corporate Policies Restricting Trading by Insiders*, 57 J. FIN. ECON. 191, 192 (2000) (arguing that even though research focuses on federal regulations, internal regulations are also widespread).

[146] *See* WANG & STEINBERG, *supra* note 19, § 2.3.2, at 35 (describing how passive companies were about employees using their respective positions for personal gain).

[147] Corporations cannot impose fines or criminal penalties; only public law can do that. *See* Frank H. Easterbrook, *Insider Trading as an Agency Problem, in* PRINCIPALS AND AGENTS: THE STRUCTURE OF BUSINESS 81, 94 (J. Pratt & R. Zeckhauser eds., 1985).

A company prohibition on insider trading would also be difficult to draft and enforce, even if the firm were fully aware of the insiders' conduct. The law of insider trading is complex with respect to issues like materiality and scienter. *See supra* note 82. It would be difficult for a firm to draft a policy covering all these issues.

[148] *See* Carlton & Fischel, *supra* note 1, at 858-59, 894.

[149] *See id.* at 864.

[150] Thomas A. Lambert, *Decision Theory and the Case for a Disclosure-Based Insider Trading Regime* 14 (U. Mo. Sch. of Law, Legal Studies Research Paper No. 2012-18, 2012), *available at* http://ssrn.com/abstract=2082521.

[151] *Id.* at 18.

Unable to determine the insider's reasons, outsiders and market makers could only guess and adjust the stock's price accordingly.[152]

Insiders could counter erroneous inferences by denying that they were exploiting inside information. When insiders who *were* using non-public information traded, then, what would happen?[153] If the market overreacted, could the insider withdraw her trading order? An order would be executed, then, only if the market underreacted. In that case, outsiders and market makers could protect themselves only by ceasing to trade until the insider either withdrew her order or disclosed the non-public information. In other words, the markets would temporarily cease to function.[154]

Another problem with letting each company set its own rules is that the stock of any company refusing to impose an effective ban on insider trading would fall in value.[155] Shareholders of such a company would have a legitimate complaint that they should not have to bear the resulting losses,[156] particularly because the directors deciding to allow insider trading would be among the potential beneficiaries of that policy, making their decision self-interested.[157]

More importantly, although individual companies could forbid insider trading, this would not be as effective as a public ban. At the least, it would substitute thousands of company-specific rules against insider trading for the current uniform rule. Recall that the primary supposed benefit of insider trading is its efficiency with regards to rewarding corporate innovators.[158] To make the incentives effective requires a determination of which insiders were permitted to trade on each bit of inside information.[159] One problem of implementation would

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[152] *Id.* (stating that requiring trading reports could result in the filing of reports even when insiders are trading on the basis of nonpublic information).

[153] *Id.* (proposing that to prevent such happenings, a "wolf crying" regulation be established).

[154] Lambert, *supra* note 150, at 18-19.

[155] *See* Mendelson, *supra* note 110, at 477-78; Persons, *supra* note 110, at 187; Wang, *supra* note 110, at 29-30.

[156] Some commentators view inside information as property owned by the corporation. *See* BAINBRIDGE, *supra* note 1, at 599, 604. However, that property now belongs, in effect, to the shareholders, for whom the directors are fiduciaries. It therefore seems inappropriate that the board approve a change in policy that would shift value from the shareholders to corporate insiders without compensation. Of course, if a company announced that it permits insider trading before it went public, public investors would then be on notice and could not complain that they were being fleeced. *Id.* at 605-06.

[157] *See* Persons, *supra* note 110, at 189.

[158] *See supra* notes 12-14 and accompanying text.

[159] *See* BAINBRIDGE, *supra* note 1, at 599-600.

be that the determination would have to be made by corporate officials after the information was disclosed to them.[160] This would entail, *inter alia*, substantial delay and the possibility of leakage of the information.[161]

Furthermore, it is rare that an innovation can be ascribed entirely to one person.[162] Sorting out who contributed to every innovation will usually be difficult, and often contentious. "Victory has a hundred fathers, but defeat is an orphan."[163] The company would have either to let all contributors trade or allot individual rations to each contributor. The former approach raises the possibility that minor players would reap as much or more profit than the main innovators, which would severely erode the effectiveness of the program in rewarding innovation.[164] In the latter approach, the resulting complexity and potential for resentment seem overwhelming.[165]

A particularly important question becomes the insider trading rights of the directors themselves. At least in theory, the board is the corporation's supreme governing body.[166] Presumably, then, a good board adds corporate value. If it does not, should the directors resign? On the other hand, recognizing that the board does not participate in operations, would employees resent the profits reaped by directors (who typically meet only one day per month) from knowledge generated by the employees? There seems to be no satisfactory solution to this dilemma.

The inevitable logistical difficulties of allocating insider trading rights also evidence the conceptual problem with using insider trading as compensation. If a board can identify the contribution of each employee to an innovation, it can better reward that employee directly rather than through the allocation of insider trading rights. One argument for insider trading is that "it allows a manager to alter his compensation package in

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[160] *Id.*

[161] *Id. See also* Haft, *supra* note 79, at 1062-63.

[162] *See* Haft, *supra* note 79, at 1062-63.

[163] Count Galeazzo Ciano, THE OXFORD BOOK OF QUOTATIONS 203 (Angela Partington ed., 4th ed. 1992).

[164] Manne conceded that many employees could trade on inside information without having contributed at all to any innovation. MANNE, *supra* note 1, at 173.

[165] Robert Haft envisions damage to firm morale as lower level employees "recognize that each succeeding level upward possesses greater financial resources and over-all knowledge of corporate activities than the last." Haft, *supra* note 37, at 1057. The resentment would be even greater for those who felt that their contribution to innovation had not been properly recognized.

[166] *See, e.g.*, DEL. CODE. ANN. tit. 8, § 141(a) (2012) ("The business and affairs of every corporation . . . shall be managed by or under the direction of a board of directors.").

light of new knowledge, thereby avoiding continual renegotiation [of his incentive compensation package]. The manager, in effect, 'renegotiates' each time he trades."[167] In other words, the argument for insider trading assumes that a board cannot apportion credit for innovation.[168]

If that is true, though, the board also cannot make detailed allotments of insider trading rights.[169] It can only permit insider trading by all employees, or by a designated class of "innovators."[170] Under the former approach true innovators will try to hide their innovations from colleagues, so as to preserve the insider trading opportunities for themselves, thereby constricting the free flow of information needed for efficient operations.[171] Nonetheless, it is virtually impossible to pursue an innovation without other employees learning about it, so inevitably, much of the insider trading profits will be reaped by others.[172]

If instead a board limits insider trading to a designated group of "innovators," it will provoke tremendous resentment among excluded employees whose jobs have been tacitly labeled routine or ministerial, or not the kind of work that can add value.[173] Those in the honored group, though, would be free to profit from inside information that has nothing to do with innovation, such as an unexpectedly good or bad earnings report.[174] They would also be approved to reap insider trading profits even when they contributed nothing to an innovation.[175] Thus, true innovators will still be motivated to hide their innovations.

Equally important would be the provisions for enforcement of insider trading bans. Violation of a company rule would not automatically give rise to shareholder standing to sue. Because it is impossible, even in theory, to identify particular victims of insider trading,[176] no shareholder could sue directly. It is disputed whether

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[167]Carlton & Fischel, *supra* note 1, at 870-71.

[168]*See* Mendelson, *supra* note 110, at 487-90 (discussing Professor Manne's view that entrepreneurs' compensation is inadequate).

[169]*See* BAINBRIDGE, *supra* note 1, at 591.

[170]*See id.* at 590-91.

[171]*See supra* note 79 and accompanying text.

[172]*See* Stephen M. Bainbridge, *Incorporating State Law Fiduciary Duties into the Federal Insider Trading Prohibition*, 52 WASH. & LEE L. REV. 1189, 1256 (1998).

[173]Haft, *supra* note 79, at 1057-58.

[174]*Id.* at 1060, 1062.

[175]MANNE, *supra* note 1, at 156.

[176]*See* BAINBRIDGE, *supra* note 1, at 594 ("Insider trading is said to harm investors in two principal ways. . . . Neither argument proves convincing on close examination."); WANG & STEINBERG, *supra* note 19, at 68 ("[Discussing] [t]he [p]ractical [d]ifficulty of [i]dentifying [t]hose [h]armed by an [i]nsider [t]rade."); Wang, *supra* note 110, at 34-35.

insider trading even damages the corporation.[177] Operating under the assumption that it does, only the board can sue for injuries to the corporation, unless a majority of the directors are so personally interested in the matter that bringing a lawsuit would entail suing themselves.[178] Outsiders would be left to wonder how diligently the board would ferret out and prosecute inside traders.

Even a board trying to be diligent lacks the monitoring mechanisms capable of making a difference.[179] Insiders can either hide their trading from management or refrain from trading personally but sell their information to tippees.[180] The SEC and the exchanges can monitor the stock market for unusual trading.[181] Even then, it is difficult to catch a clever inside trader.[182] Without reliable monitoring devices, even a committed board might not be very effective.[183]

It would, moreover, be understandable that a sophisticated board might not want to pursue or punish insider trading too vigorously.[184] As soon as the board starts to proceed against one of its own officers, the trust between them, that is essential to effective governance, is broken. And that may be true not only for the executive(s) charged, but for all the company's officers, since management tends to view itself as a team, with interests somewhat separate from those of the board. That possibility is not currently a problem because insider trading is illegal

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[177] *See* Carlton & Fischel, *supra* note 1, at 872-74 (arguing that the incentives created by insider trading would help to overcome managers' excessive aversion to risk, and that the malign intentions of any single manager would be defeated by the interests of the broader team dealing with any particular project); RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 449 (7th ed. 2007) (arguing that permitting insider trading could overcome managers' excessive risk aversion). *See also* BAINBRIDGE, *supra* note 1, at 574-78 (discussing competing views on whether insider trading injures the corporation). Of course, if insider trading is efficient compensation, then its legalization should benefit the corporation. *See supra* notes 9, 11 and accompanying text.

[178] *See, e.g.*, Aronson v. Lewis, 473 A.2d 805, 811, 815 (Del. 1984) (illuminating the practical realities and limitations of derivative actions).

[179] *See* Bainbridge, *supra* note 172, at 1263-64 & n.306 (discussing the SEC's advantages in detecting and prosecuting insider trading).

[180] *See* BAINBRIDGE, *supra* note 1, at 600.

[181] *See* Bainbridge, *supra* note 172, at 1263-64.

[182] *See id.* at 1264.

[183] WANG & STEINBERG, *supra* note 19, at 35 ("[E]ffective monitoring of insider trading may require computerized surveillance of the entire trading market."). *See also* Bainbridge, *supra* note 172, at 1263-64 ("Informants, computer monitoring of stock transactions, and reporting of unusual activity by self-regulatory organizations or market professionals are the usual way in which insider trading cases come to light. As a practical matter, these techniques are available only to public law enforcement agencies.").

[184] BAINBRIDGE, *supra* note 1, at 575.

and violations can be pursued by the SEC and individual investors; the board almost always stays *hors de combat*.[185] If insider trading were legalized, the board could no longer rely on others to move against it.[186]

In sum, it is hard to see how reliance on the market to deter and to sanction insider trading could be nearly as effective as the current (admittedly imperfect) system under federal law.[187] At the least, a private system would leave considerable uncertainty in the trading public. Even if a company were perceived to be essentially free of insider trading, substantial changes in management or in the composition of the board might raise questions about whether substantial insider trading might be in the offing. Public investors would have to continuously monitor and price the risk of insider trading in each public company.

Especially for smaller companies, the costs of such an effort would often exceed the potential returns, so that trading in and public ownership of these stocks would decline–perhaps to the point where the costs of public ownership would exceed the benefits for many companies.[188] These companies would then go private.

Nonetheless, companies going public should be allowed to opt out of insider trading prohibitions if they disclose that policy.[189] If investors are warned of the policy, they cannot later complain about it.[190]

VI. INSIDE INFORMATION AS CORPORATE PROPERTY

Some commentators view insider trading in terms of property rights to information.[191] Some would allocate that property right to managers.[192] This would lead to all the problems with insider trading already discussed.

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[185]*Id.* at 609.

[186]*Id.* at 602-04 (discussing corporate liability exposure when agents engage in insider trading).

[187]*See* Bainbridge, *supra* note 172, at 1263-66.

[188]*See* POSNER, *supra* note 177, at 449 (discussing the costs of enforcing rules against insider trading).

[189]Opting out by companies that are already public would be unfair to existing shareholders, who would presumably see the price of their stock fall. *See supra* note 110 and accompanying text. Perhaps these companies should be allowed to opt out of insider trading laws if they held their existing shareholders harmless, but it is hard to see how that could be done.

[190]*See* Bainbridge, *supra* note 172 and accompanying text.

[191]BAINBRIDGE, *supra* note 1, at 598-607; Carlton & Fischel, *supra* note 1, at 861-66, 878-79. *See also* Ian Ayres & Stephen Choi, *Internalizing Outsider Trading*, 101 MICH. L. REV. 313, 326-27 (2002).

[192]*See* Carlton & Fischel, *supra* note 1, at 866-72.

Stephen Bainbridge argues for assigning the property right to the corporation.[193] This argument, however, raises the question: how can a corporation exploit that right, especially with respect to its own stock?[194] Bainbridge never addresses this question.[195] If the corporation reassigns the right to managers, we have all the problems already discussed.[196]

The corporation could instead trade for its own account. However, the board of directors (which would have to authorize such trading) owes fiduciary duties to the shareholders, who would be on the other side of trades for the firm's own account.[197] The law now does not currently permit this.[198] "The issuer itself cannot trade on its own stock based on material nonpublic information."[199]

It is hard to see why that rule should be changed. The corporation itself is a legal fiction, not a real person; it has no interests apart from those of its constituents.[200] In theory, the premier corporate constituents—those to whom fiduciary duties are owed—are the shareholders because only shareholders have the proper incentives to maximize efficiency.[201] It would, then, be inconsistent with efficiency for a corporation to trade against its own shareholders for the benefit of some other constituency, such as its employees.

Nor would it make economic sense for the firm to trade at the expense of shareholders trading the other way and for the benefit of non-trading shareholders.[202] First, the possibility of such trading creates an

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[193]BAINBRIDGE, *supra* note 1, at 604 ("[T]he argument for assigning the property right to the insider is considerably weaker than the argument for assigning it to the corporation.").

[194]Sometimes inside information creates opportunities for profit from trading the securities of another company. For example, if Raider decides to bid to acquire Target's stock at a premium over its current market price, Raider could profit by first buying some of Target's stock at its current price and then profiting from the expected increase in that price when the bid is announced. *See* BAINBRIDGE, *supra* note 1, at 655, 657-58 (describing pre-announcement purchases by raiders).

[195]*Id.* at 655.

[196]*See supra* Part V.

[197]*See* Bainbridge, *supra* note 156, at 1218, 1223.

[198] *Id.*

[199]WANG & STEINBERG, *supra* note 19, at 310.

[200]*See* Frank H. Easterbrook & Daniel R. Fischel, *Voting in Corporation Law*, 26 J.L. & ECON. 395, 401 (1983).

[201]The "theory of shareholder wealth maximization has been widely accepted by courts over an extended period of time." BAINBRIDGE, *supra* note 1, at 413. This is consistent with the dominant economic theory. *See id.* at 408-10; *see also* Bayless Manning, *Thinking Straight About Corporate Law Reform*, 41 LAW & CONTEMP. PROBS. 3, 21 (1977) (stating that only shareholders have the "perspective of the aggregate"); Easterbrook & Fischel, *supra* note 200, at 403.

[202]*See* Mendelson, *supra* note 110, at 479-80 (discussing the corporation as the

irreconcilable tension with the corporation's public disclosure policies.[203] Corporations are urged not to give the minimum disclosures at the last possible moment required by law, but to give the fullest and earliest disclosure of information consistent with the strategic needs of the business for secrecy.[204] A corporation trading for its own account, however, would have an incentive to disclose as little and as late as permitted by law, in order to maximize the opportunities for trading profits from insider information. A general reduction and delay in the information disclosures by public companies would make securities markets less efficient.

More important, trading by a corporation in its own stock for the benefit of one group of shareholders at the expense of another group violates the principle that the board should not discriminate among shareholders without good reason.[205] Here, no such reason is evident. All shareholders bought their stock at some time (or received their stock gratuitously in a chain from someone who did buy), and all shareholders eventually dispose of their stock. Shareholders who trade often do so because of personal financial exigencies;[206] they are not committing any wrong for which they deserve to be exploited by the companies in whose stock they trade.

A rule of "caveat trader" would not benefit investors generally; it would only disadvantage investors who trade more than investors who trade less. However, the efficiency of stock markets depends on a steady flow of trading.[207] Insider trading by issuers would discourage trading, with resultant damage to the efficiency of stock markets[208] but no offsetting benefits to investors.

In sum, it would be a bad idea to treat inside information as property that belongs to the corporation, able to be exploited in trading for its own account.

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insider).

[203]*See* Donald E. Pease, Delaware's Disclosure Rule: The 'Complete Candor' Standard, Its Application, and Why Sue in Delaware, 14 DEL. J. CORP. L. 445, 446-47 (1989).

[204]*See id.*

[205]*See* Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 957-58 (Del. 1985).

[206]*See supra* Part IV.

[207]*See* Haft, *supra* note 79, at 1051 ("If the public believes that the game is unfair and chooses not to play, the markets will suffer and the efficient allocation of capital will be impeded.").

[208]*See id.* at 1064 n.33.

VII. CONCLUSION

A persistent band of commentators continues to claim that insider trading is beneficial or, at least, so innocuous that it should be legal. However, these arguments all presume that the level of insider trading would remain low even if it were permitted, because it would be limited by the personal wealth of individual insiders. This Note has shown that this assumption is unwarranted.

If insider trading were legal, insiders could easily obtain outside financing to exploit their informational advantage, and they would have no reason not to do so. This would drive the disadvantaged outsiders from the stock markets, thereby drastically reducing public ownership of corporations, which would also effectively end insider trading. Individual corporations lack the means and the incentives to curb insider trading on their own. It would also be unwise to treat inside information as property belonging to the corporation that can be exploited in trading for its own account. Corporations are supposed to operate for the benefit of their shareholders, not to fleece them for the benefit of some other constituency or some subset of shareholders. Accordingly, there is no plausible argument for legalizing insider trading.