Trading on Inside Information
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Inside trading is unfair. Equal access to information is essential to confidence in the markets. So inside trading is unlawful. Such is the received wisdom. Received wisdom is not always right. “Everybody knew”, once, that light propagates through an æther and that the sun revolves around the earth. Trading on inside information is a complex phenomenon, well worth study rather than ukase. People could choose different aspects to examine. Our focus is the relation between insider trading and fiduciary duties. Whether investors would want managers to trade on particular information depends on the effect trading has on shareholders’ wealth. This in turn depends on whether a firm’s managers or its investors value more highly the property right in information. We discuss this and the related issue whether firms can allocate the property right in valuable information by contract. We then look at the state and federal rules regulating insider trading. We have written separately about this topic and have reached conclusions that differ in emphasis about its likely effects. We offer here not resolution but assessment. Before addressing substantive issues, however, we define “inside trading.”
The Meaning of Inside Information

One definition is trading by parties who are better informed than their opposite numbers. No market could exist with such a broad definition of prohibited trading. If each trader has the same information as every other, there is little incentive to trade. More important, there is no incentive to acquire information in the first place if the opportunity to profit by virtue of superior information is eliminated. And if there is no incentive to acquire information, markets lose their function of providing price signals to diverse participants in the economy.

An alternative definition is trading by those with unequal access to information. Managers are said to have “unequal access” and so are forbidden to trade when the news is “material.” The difficulty with this definition is timing. Unequal when—before the information comes into being, or after? An analyst has valuable information. Does everyone have “equal access” because anyone could have hired the analyst or become one himself? The same can be said in the case of corporate managers. Corporate managers have access to information, which is valuable in the market. If one who is an “outsider” today could have become a manager by devoting the same time and skill as today's “insider” did, is access to information equal or unequal?

There is no principled answer to such questions.

Better, then, to identify property rights in information. Trading by managers (or others) in possession of valuable information is appropriate if the insiders own that information. They may get the right by dint of hard work (as stock analysts do when evaluating obscure clues about a firm’s performance), or generate it themselves (as tender offer bidders create the news about their own future acts), or buy it from the firm (as managers may do expressly or implicitly). Or traders may steal news from others who create or own the information. Such an approach replaces the unanswerable “what is inside information?” question with tractable matters of contract. We may ask whether certain persons do (or should) own the right to use information. Still difficult problems abound. Perhaps the most difficult is whether managers should be deemed to own valuable information obtained during their tenure.

Before we turn to this, a warning.

Much of the lore about inside trading treats it as a unitary phenomenon, typified by the corporate manager who learns that the firm has struck a mother lode and then buys stock before the news escapes, depriving unsuspecting public investors of their profit without having done anything to make gains more common. Those who decry inside trading as “unfair” concentrate on such episodes. Rhetoric being what it is, the name—freighted with this nasty connotation—is applied to quite different activities that the speaker wishes to condemn. None of the Supreme Court’s “inside trading” cases deals with the manager who trades ahead of public release of corporate news. Vincent Chiarella, a printer, decoded the name of a tender offer target and bought its stock before the bid could be announced. Ray Dirks, a stock analyst, nosed out a fraud at a widely held firm and alerted his clients to sell. R. Foster Winans, a writer for the Wall Street Journal, told friends to buy the stocks to be touted in forthcoming columns.

These are vastly different problems. Chiarella broke his promise to his employer's customer, effectively stealing information—but it was information the client had every right to use for his own benefit without telling investors. Dirks nased out a scam, and the right to reveal the news to his own clients compensated him for his efforts, which leads to more digging by other analysts. Winans broke his contract and in so doing dragged down the reputation of the Journal for honest reporting. All of these cases may be resolved without reference to the inside trading paradigm, although all equally may be resolved by using the property rights approach we discuss.

Other cases tagged “inside trading” present still other kinds of problems. “Warehousers” who line up stock in advance of a tender offer on the bidder’s tip have consensual access to the information they use; the legal status of their conduct depends on whether their stock counts as part of a group for purposes of the pre-bid limits in the Williams Act; this is independent of any conventional approach to inside trading. Investment bankers who use information obtained from clients to sabotage their clients’ plans—by leaking the news to rivals, by taking the opposite side in trades, and so on—not only break their contracts but also are knaves whose deeds reduce the efficiency of markets. Again their acts may be condemned without asking complex questions about inside trading. We put such matters to one side for now and concentrate on the paradigm.


Why Firms Might Allocate to Managers Property Rights in Information

Trading by insiders (for this purpose, managers and their tippees) may provide firms with a valuable mechanism for communicating information to market participants. Allowing insiders to trade may also create incentives to maximize the value of the firm to the benefit of insiders and outside shareholders alike.

Trading and the Transmission of Information

The better stock prices reflect information, the more useful they are as a guide to capital investment. From the perspective of any one firm, however, efficient capital markets are a public good. Why, then, does a firm disclose information about itself?

One reason is that disclosure can reduce wasteful expenditures on search and reduce investors' uncertainty about the firm. A second is that disclosure of information by the firm may enable the firm's current investors to sell their shares to outsiders at a higher price, on average. If the firm discloses no information, outsiders may assume the worst and discount the price they are willing to pay for shares by a factor that reflects their uncertainty. Finally, accurately priced securities give firms information about whether their managers are successful. Markets for managerial services and for corporate control then function more effectively. Better managers signal their quality by willingness to tie a higher proportion of their compensation to stock performance. Accurate prices then enable these managers to receive the rewards for their superior performance.

Complete disclosure, however, would not make sense. Disclosure is costly, and at some point these costs exceed the benefits of increased disclosure. Too, disclosure might destroy the information's value. It would not be in investors' interest to disclose, for example, that a confidential study revealed the presence of valuable ore on land the firm seeks to purchase. Information about plans for tomorrow's products or acquisitions also is less valuable if released.

Investors would like the price of the stock to reflect the value of this information, without the information itself coming out. The combination of desires is hard to achieve, but trading by insiders may help. If managers trade, the price of stock moves closer to what it would have been had the information been disclosed. The effect may be powerful when trading joins with partial or vague disclosures ("We have good news but can't say just what"), for outsiders who see insiders put their money where their mouths are will be more likely to credit the firm's statements. The same effect occurs when insiders' trades imply the truth of more concrete disclosures.

Whether trading (without disclosure) can move the price close to the one reflecting full information depends on the amount of "noise" surrounding the trade. The greater the ability of market participants to identify insider trading and deduce its cause, the more information such trading conveys. At the extreme, trading by insiders is as revealing as disclosure. But as insiders limit the size of their positions because of risk aversion and camouflage their trading to some degree, they convey less information by trading than by (credible) disclosure.

Insider Trading as a Compensation Device

Firms try to deal with the agency costs of management by writing contracts that compensate managers for acts that assist investors and penalize them for failure. Contracts that provide for periodic adjustments based on (imperfectly) observed effort and output are superior to contracts that fix compensation in advance of either effort or results. Adjustment by renegotiation is hard given the difficulty of monitoring the effort and measuring the output of individual managers. To reduce the costs of contracting, firms seek to minimize the number of renegotiations by choosing "incentive compatible" arrangements, which link managers' and investors' fates automatically.

Inside trading allows a manager to alter his compensation package in light of new knowledge, avoiding continual renegotiation. The manager "renegotiates" each time he trades. This in turn increases the manager's incentive to acquire and develop valuable information in the first place (as well as to invest in firm-specific human capital). A manager who observes an investment for the firm—such as a potential value-increasing merger or a new technology—will be
more inclined to pursue this opportunity if rewarded on success. The alternative is to tell others of the opportunity, explain that it can be realized with extra effort, and hope to be compensated by some form of ex post settlement. Insiders’ trades reduce the uncertainty and cost of renegotiation and thus prod managers to produce valuable information. Moreover, because managers determine the frequency of trades, they can tailor their compensation scheme to their attitudes toward risk.

Inside trading also provides firms with valuable information concerning prospective managers. Because trading rewards managers who create valuable information and are willing to take risks, managers who most prefer such compensation schemes may be those who are the least risk averse and the most capable. Self-selection reduces the costs of screening potential managers, the monitoring costs created by risk-averse managers, and the opportunity costs from suboptimal investment decisions.

**Why Firms Might Restrict Trading on Inside Information**

We have offered a number of reasons why shareholders’ wealth may be greater if managers who possess valuable information are allowed to trade. But it does not follow that investors always benefit if anyone in possession of valuable information may trade. Here are some reasons why firms might restrict the use of their information.

**PREVENTING THEFT**

Trading on information can be a form of theft. Firms regularly forbid lawyers, accountants, printers, and others to trade on news about the firm. Those who trade notwithstanding promises not to do so are stealing assets of the firm as surely as if they reach into the till for cash exceeding their salaries. Contractual bans on trading were customary long before federal law entered the picture. Persons who are responsible neither for creating the information nor for selecting the business projects that generated it (a category that includes lawyers) promise not to use it. Even employees who create information— inventors, salesmen compiling customer lists—frequently assign it to the firm by contract.

Consider Vincent Chiarella, a printer who received information about imminent takeover bids. Potential acquirers have powerful reasons to maintain secrecy until they announce their bid, and the bidders encoded the information provided to their printer. Chiarella deciphered the code and bought shares of the targets, which he resold at a profit as soon as the announcements of the bids drove up the price. Chiarella appropriated value from the bidders. The harm to them depends on the extent to which Chiarella’s trading increased the cost of the acquisition or, by alerting the target, reduced the probability of success. Appropriation of information from another reduces the efficiency of capital markets, and it is harmful (and should be forbidden) for exactly the reasons theft is harmful.

**PERVERSE INCENTIVES**

Inside trading may create a moral hazard. For example, the opportunity to gain from trading may induce managers to increase the volatility of stock prices so they will have more opportunities to make profitable trades. They may do this by choosing risky projects for the firm. The greater the volatility of prices, the greater the opportunity for trading profits even if the projects have lower mean returns than other options.

Prospects of trading also could induce insiders to create bad news. Advance knowledge allows profitable trading whether the news is good or bad, and bad news is easier to create. At the extreme, if bad information yields private profit, managers may be indifferent between working to make the firm prosperous and working to make it bankrupt.

**ATTITUDES TOWARD RISK**

Shareholders who have the ability to hold diversified portfolios are efficient risk-bearers. Managers, by contrast, hold much of their wealth in human capital, which, together with much of their financial capital, is committed to a single firm. Managers thus want to reduce risk that shows up in the volatility of their compensation. Most would prefer the certainty of a $100,000 salary to a salary of $50,000 and a 10 percent chance of a bonus of $500,000, even though the two have the same expected value. Inside trading then may be an inefficient compensation scheme. It amounts to paying managers in lottery tickets. The package costs the shareholders the actuarial value of the payoff, but risk-average managers value the ticket at less than that.

**UNFAIRNESS**

Public debate pays little attention to the problems with inside trading we have identified. “Fairness” is the refrain. Managers’ trading is said to be “unfair” because information “intended for a corporate purpose” should not be put to private use.

To the argument that managers pay in advance, through lower salaries, for the opportunity to reap these gains, throngs respond: “No they don’t; they get the salary and the profits too.”

Assertions of this stripe beg the question whether information is “intended for a corporate purpose.” Information does not “intend” things; people intend things, and they intend to maximize wealth. If the information is more valuable to the firm, then managers will be forbidden to trade; if the right is more valuable when held by managers, they will exercise it. Investors seek to maximize expected returns rather than the payoffs in each case. When unequal divisions contribute to higher expected returns, investors prefer inequality. They can get the norm by diversifying their holdings. So if some risk of not receiving a gain today (because insiders buy the shares) goes hand in glove with higher average returns over all firms (because the opportunity to trade is useful in inducing managers to create more gains), investors prefer the risk and the higher return. It is not “unfair” to investors to use a device that makes them wealthier! Most of those who think trading unfair assume that investors want managers to be treated “just like me.” Why would a sane investor wish

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3. The catchphrase is from In re Cady, Roberts & Co., 40 S.E.C. 907 (1961), the Commission’s leading decision denouncing managers’ trading. The Supreme Court picked up the phrase in Dirks, 463 U.S. at 653–54.
firms, the effects of trading depend on the context and positions of the employees involved. Firms that allow top managers to trade may want to preclude the general counsel from trading in advance of a takeover bid, or engineers from trading in advance of a patent.

That no uniform rule is optimal implies that the subject is best left to negotiations between insiders (and others) and the firm. Firms and insiders have strong incentives to allocate the property right in valuable information to the highest valuing user, as with patents. If, as many say, shareholders' wealth plummets when insiders trade on nonpublic information, both insiders and shareholders will gain from prohibiting the practice. Such contracts are negotiated routinely with investment bankers, lawyers, scientists, and salesmen.

Perhaps the difficulty of enforcing such contracts makes it impossible for firms to achieve optimal allocations of the rights. Insiders' trading is notoriously hard to detect. If firms seeking to curtail insiders' trading by contract cannot enforce their choices, then the benefits are lost. Firms that gain from the restrictions cannot distinguish themselves (in investors' eyes) because other firms will disingenuously claim to be similarly restrictive. Firms might attempt to overcome this by requiring insiders to report their trades and auditing their tax returns. Yet such devices are imperfect, for insiders can provide valuable information to family members or others and avoid detection. Although firms may try to detect trades by entering into agreements with stock exchanges that have computer surveillance of trading patterns, the difficulty of tracing sources of information necessarily means that enforcement will be spotty.

If the probability of detecting improper trades is low, public enforcement may be best. When detection is highly unlikely, the optimal fine can exceed the net wealth of the offender. Thus public enforcement, which can lead to imprisonment and other penalties firms cannot adopt for themselves, may be efficient.

Two caveats. First, public enforcement creates costs of its own (including the possibility of overdeterrence) that must be compared with the costs of imperfect private enforcement. Second, even if public enforcement is superior, this does not justify prohibition of trading itself unless enforcement is so weak that firms desiring to enforce no-trading rules cannot do so in a market of mixed trading and abstinence. Whether there should be public enforcement is distinct from whether there should be a ban in the first place. Public enforcement of antitheft laws does not imply that consensual transfers of property ought to be forbidden; just so with inside trading rules.

Legal Rules Restricting Inside Trading

We turn to the rules governing inside trading. Although conclusions must be tentative because theoretical arguments on the economic effects of inside trading are inconclusive, economic analysis provides insights.

Common Law

At common law, managers and other insiders may trade the stock of public corporations on the basis of their inside information unless obliged by contract not to. Insiders need not disclose what they know. When federal securities laws do not apply (for example, when the transaction does not take place in interstate commerce), this is contemporary law.

Some jurisdictions, following the lead of the Supreme Court in a case decided under federal common law, condemn trading if the plaintiff proves "special facts"—that his trade was induced by express or implied misrepresentations concerning the value of the securities or the identity of the purchaser. Corporations also have been allowed to recover under the corporate opportunity doctrine from insiders who take advantage of their knowledge in ways that harm the firms' business. For example, an employee who, upon learning of an impending land purchase or corporate repurchase plan, rushes out and purchases the land or shares in order to resell to the firm at a high price would be held to have usurped a corporate opportunity.

The "special facts" rule is easy to understand. If the insider (or someone acting on his behalf) makes misrepresentations about the value of the firm or his identity in convincing an
uninformed outsider to sell, any informational benefits of the trade are lost. Indeed the trade, like other types of fraud, moves prices away from, rather than toward, the “correct” price, particularly if the trade is a face-to-face transaction as opposed to an impersonal one. Moreover, the incentive created by allowing such trades is to distort information as opposed to producing new information. The “special facts” rule, therefore, grows out of recognition that trading by insiders is not always efficient. Permitting trades in public corporations and prohibiting them in close corporations shows a close correspondence between the common law and economic analysis.

The rationale for applying the corporate opportunity doctrine to insider trading is also clear. Actions based on insider information that harm the firm are prohibited—if not by contract, then by implication in the absence of a writing. In the land case, the firm must negotiate with the employee instead of buying in a competitive market. Transaction costs and prices have risen. Similarly, the purchase of a target’s shares in advance of a takeover probably usurps the bidder’s opportunity. The action may drive up the price of the target firm’s shares or tip the bidder’s hand, making the acquisition less likely to succeed.

SECTION 10(b) AND RULE 10b-5

Courts have interpreted Section 10(b) of the Security Exchange Act of 1934 and the SEC’s Rule 10b-5 to require corporate insiders and tippees either to disclose material information or to abstain from trading.

Disclose-or-Abstain-from-Trading

Section 10(b) and Rule 10b-5 do not prohibit insiders from trading; they proscribe fraud. Trading after full disclosure is not “fraud.” Insiders therefore may either disclose the nonpublic information and trade, or keep silent and refrain from trading when withholding material nonpublic information amounts to fraud. Despite this formulation in the alternative, the rule effectively prohibits trading (provided other elements such as materiality are present). In many cases, the insider may not be able to disclose the information. For example, the information might be valuable to competitors. It is in precisely such situations that inside trading may provide firms with a valuable method of transmitting information to the market by price without revealing the details. Compulsory disclosure removes firms’ ability to use inside trading when it is most needed. We end up with neither trading nor disclosure.

When disclosure is possible and not harmful to the firm, the release of news to an efficient capital market eliminates gains from trading. This is undesirable to the extent that the lure of profits from trading gives managers an incentive to maximize the value of the firm. The disclosure-or-abstain-from-trading rule weakens this incentive. Effects extend beyond managers. Investment analysts deemed “inside traders” when they acquire news may be discouraged from searching. Prospective tender offerors also search less to the extent they cannot use information about their own plans to increase the chance their bid will succeed. Problems would be fewer if courts and regulators would distinguish between consensual and nonconsensual uses of information. Ray Dirks exposed one of the largest securities frauds in recent years, at the price of telling his clients what was afoot; the SEC should have given him a medal even while condemning forms of inside trading that injure investors.

“Material” Inside Information

The effect of Rule 10b-5 should not be exaggerated. The disclose-or-abstain-from-trading rule applies only if a defendant trades on the basis of “material” inside information. That means big news, such as an impending merger or a major change in earnings. Trades motivated by knowledge of “bombshell” events are the substance of lawsuits but the aberration in practice. Most news is less dramatic; insiders remain free to trade on their knowledge. Knowledge that one of the firm’s top managers is dispirited because of family problems, for example, may be very valuable but is almost surely not legally material. As long as insiders own and trade shares, therefore, Rule 10b-5 is likely to have slight effect on insiders’ ability to outperform (and inform) the market.

There is more. Because of their superior access to information, insid-
ers will outperform the market without trading. Their knowledge may tell them not to sell at times the less well informed would sell. Knowledge about the industry may be the basis of trading in other firms’ stock—trades on the basis of “material” information, often, but not “inside.”

The materiality requirement tends to limit the operation of Rule 10b-5 to inefficient insider trading. Lawyers, accountants, brokers, printers, football coaches, and public officials receive valuable information after it has been produced and are not responsible for (and incur none of the costs of) the risky decisions that led to its generation. Because the benefits of allowing them to trade are trivial, the firm may want to ban such trading. Explicit contracts between firms and these outsiders typically require confidentiality and bar trading. Rule 10b-5 puts teeth into these promises. Most of the inside trading cases brought in the last decade involve conduct squarely prohibited by contract. In the rare cases of bombshell events, where the rewards are large and uncertain, the value of the uncertain trading profits to risk-averse managers (and others) will be low compared to the expected value of the event. Here again inside trading might be an inefficient compensation scheme. In both classes of cases, firms might want to ban inside trading, but because the precipitating event is so rare (and perhaps because the enforcement costs are so high) it is not worth the cost of including the prohibition in a contract. If the materiality requirement acts as a filter distinguishing these two classes of cases from the more typical but less dramatic cases where insiders earn positive abnormal returns, the rule may turn out to be beneficial without regard to the damage a general ban could do.

Fiduciary Duty

The Supreme Court has drawn a line between the ability of managers to trade on material inside information and the ability of others, such as printers or government officials, to do so. Because managers are employed by the firm and thus owe a fiduciary duty to investors, the Court has reasoned, they may not trade on the basis of inside information. Outsiders owe no such duty and so may trade without violating Section 10(b) or Rule 10b-5.

“Fiduciary duties” are a dubious basis on which to distinguish insiders from others. The difficulty with limiting the class of “insiders” to those within the firm is that long-term contracts are often a substitute for horizontal or vertical integration. Outside suppliers or outside counsel may have as much inside information and ability to affect the fortunes of the firm as employees. Under current rules, for example, a supplier to a firm could not be liable for selling the shares of the firm short, but it could be liable if the supplier were vertically integrated into the firm. That’s not a useful line. Actual contracts, when we observe them, forbid trading by outsiders such as printers and messengers but not by insiders, the opposite of the result derived from an emphasis on “fiduciary” duty.

One positive outcome from the emphasis on duty, though, has been the development of the misappropriation theory. People may accept duties by agreement. If by contract a person promises not to trade, the argument goes, he has a “duty” not to trade; the identity of the misappropriating party becomes irrelevant. Consistent application of this approach would go a long way toward bringing the law of insider trading into harmony with the economics. (It is important that the corollary of the misappropriation theory also be recognized—that there should be no prohibition where the use of information is allowed by explicit contract.)

The Proper Plaintiff

Federal law creates both private and public enforcement devices. Rule 10b-5 gives shareholders who bought and sold during the time insiders were trading standing to bring private damages suits. The Department of Justice also may bring injunctive and criminal actions on behalf of the United States. Finally, the SEC may file suits to recover restitution and up to three times the trading profits from those who trade illegally.

One of the themes we emphasize is that the dispute concerning inside trading is really about how managerial and other contracts allocate the property right in valuable information. If this property right is allocated to the managers, neither shareholders nor the government should have a claim—at least, no greater claim than they would have about excessive managerial salaries. In cases of nonconsensual trading, the firm should have a claim analogous to damages for breach of contract or to recovering the value of stolen property. Shareholders could pursue derivative actions in the right of the corporations; if so it should make no difference whether the complaining shareholder traded at the same time as the insider or, for that matter, traded at all.

Because the probability of detection in situations involving nonconsensual trading is less than one, and because the gains from trading are potentially great, public enforcement is appropriate to increase the sanction (if necessary, to send to jail those whose wealth is too small to pay an optimal monetary penalty). Insider trading laws to this extent do not differ from the use of public prosecution to enforce other limitations on the use of intellectual property, such as trade secrets, trademarks, and copyrights.

Takeovers and Trading

In all corporate control transactions the acquiring firm acts through many agents with access to inside information. We have emphasized that theft of this information, as in Chiarella, is the core case for liability. Other than clapping the offender in leg irons, though, how does the legal system respond? Suppose Bidder’s lawyer uses the information to buy shares of Target. Doubtless Bidder may recover the trader’s profits. What if Bidder maintains that Lawyer’s trades caused it to pay more for Target and seeks this increment from Lawyer?

A higher price is a consequence of the trading and may create social as well as private loss. Offenders must pay for the social loss they create as well as the private gains they reap. Yet Bidder will face an uphill fight to demonstrate that it suffered loss. It is unaffected unless Lawyer’s trades lead to a higher price for Target’s stock before the bid, and that higher price forces Bidder to raise its offer.

Anonymous trades do not affect price. Other traders do not infer information from (apparently) random purchases by unheard-of persons. Unless professional investors deduced Lawyer’s identity and
inferred that something was afoot, the price of Target’s stock would notudge.

If it moves, so what? Whether investors tender at a given price depends on their next-best options—whether a bid from someone else, a buyback, or holding in the hope that the market price will adjust. This next-best option, not the market price the day the bid lands on the table, dominates what Bidder must pay. Any run-up attributable to insiders’ purchases does not affect the next-best option and therefore does not affect the price Bidder pays.

**SECTION 16**

Section 16 of the Securities Exchange Act of 1934 requires directors, officers, and large stockholders (owning over 10 percent of the firm) to report trades in equity securities of their firm on a monthly basis, provides the firm with a right to any profits made from the purchase and sale of securities in a six-month period, and prohibits short selling. Section 16 differs from Section 10(b) and Rule 10b-5 in several respects: (1) Section 16 is not limited to trading on inside information; (2) it applies only to matched purchases and sales within six months; (3) it covers only specified insiders; (4) it allows only the firm to recover.

**Reporting Requirements**

Reporting of insiders’ trades allows investors to make more accurate inferences about insiders’ compensation. Moreover, reports provide information to future managers about potential compensation that is available. An additional benefit is that the information effect of the insiders’ trades will be strengthened if trades are observable. These benefits may be small, however, because of the difficulty of inferring information from trading profits when portfolio decisions may be governed by many factors, and because those who trade in violation of contracts and substantive rules are unlikely to report their misdeeds. But because the cost of reporting is small, even a slight benefit carries the day.

**The Ban on Profit from Short-Swing Trading**

Section 16(b), which authorizes the corporation to obtain its insiders’ short-swing profits, has the advantage of directing recovery to the corporation. What is less clear, however, is whether the six-month rule serves a useful purpose. If trading is nonconsensual, it should not matter whether a matched purchase and sale occur within six months; if the trading is consensual, why should the wash matter?

One reply is that the prohibition of short-swing trading decreases insiders’ incentive to manipulate stock prices (that is, to move prices away from their equilibrium value). Suppose insiders know that their purchases cause the price of shares to rise. In this event, insiders could gain by purchasing shares and then immediately selling (or selling short) before the market became aware of the manipulation and settled back to its former level. Prohibiting matched buying and selling within a short time reduces the ability of insiders to play games of this kind.

Yet the prohibition may entail substantial costs. Both the incentive and information effects of insider trading are weakened if a substantial set of trades is off limits. The prohibition of short-swing trading also has the effect of forcing managers who buy their firms’ stock to hold nondiversified portfolios for longer periods. Firms must compensate by raising managers’ compensation from other sources. Moreover, the ability of insiders to manipulate stock prices should not be exaggerated. The reason the market price might rise if insiders purchase is that investors believe such purchases are based on (and so imply) valuable information about the firm’s prospects. Investors believe this a second time only if the message is borne out by an increase in the firm’s earnings. Manipulation is a short-run or one-shot phenomenon.

**The Prohibition Against Short Sales**

The perverse incentives created by the ability to trade are most acute when insiders engage in short selling. Many explicit contracts prohibit short sales; it is appropriate to imply such agreements widely in the absence of evidence that firms desire to permit the practice. Any corporate manager caught with a large net short position would be fired. Section 16’s prohibition against short selling enforces these enduring patterns.

The effect of Section 16 on shareholders’ welfare, therefore, is ambiguous. The reporting requirements, the prohibition against short-swing trading, and the ban on short sales all have a plausible basis, but also impose costs. No one knows the relative magnitudes of the costs and benefits—from Section 16 or from any of the other legal rules about insiders’ trading. We know a good deal more about next year’s weather than about the effects of this common commercial transaction. This makes it easy to speculate (no one can refute you) and correspondingly important to begin a concerted search for telling data.

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