Insider Trading and Investment Analysts: An Economic Analysis of Dirks v. Securities and Exchange Commission

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INSIDER TRADING AND INVESTMENT
ANALYSTS: AN ECONOMIC ANALYSIS OF
DIRKS V. SECURITIES AND EXCHANGE
COMMISSION

Daniel R. Fischel*

INTRODUCTION

Raymond Dirks is an investments analyst who persuaded his clients to sell their shares in Equity Funding of America after he received information from officials of the firm that the shares were overvalued because of a massive fraud. For his efforts, he was censured by the Securities and Exchange Commission for violating the general antifraud provision of the securities laws, Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder. The censure was upheld by the Court of Appeals for the District of Columbia. In Dirks v. SEC, however, the Supreme Court reversed Dirks' censure. Dirks, the Court stated, was a stranger to Equity Funding, with no pre-existing fiduciary duty to its shareholders. Nor could Dirks be considered a "tippee" who had a duty to disclose the information publicly, because the insiders who provided the information about the fraud received no money or personal benefit and did not intend to make a gift of valuable information to Dirks. Instead, their motivation was "a desire to expose the fraud." Thus, the Court concluded, Dirks was not "a participant after the fact in [an] insider's breach of fiduciary duty" and had

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5. Id. at 665.
6. Id. at 667.
7. Id. at 667.
8. Id. (quoting Chiarella v. United States, 445 U.S. 222, 230 n.12 (1980)).
no duty to abstain from the use of the insider information he had obtained.

Justice Blackmun, joined by Justices Brennan and Marshall, dissented. In their view, the insiders breached their fiduciary duties to Equity Funding's shareholders, regardless of their motives for doing so. That the insiders derived no benefit from the breach in no way "eradicate[s] the shareholder's injury." Moreover, the dissent emphasized, it was undisputed that, as fiduciaries, the insiders could not trade on the basis of the information communicated to Dirks. It was equally clear that, as fiduciaries, they should not be able to do indirectly what they were prohibited from doing personally. The effect of Dirks' selective dissemination of information received from insiders, the dissent stated, was "that Dirks' clients were able to shift the losses that were inevitable due to the Equity Funding fraud from themselves to uninformed market participants." Instead of revealing the information to his clients, Dirks, as a citizen, should have reported the information to the Securities and Exchange Commission and other authorities. Because he did not do so, the dissent concluded that Dirks aided and abetted the breach of fiduciary duty by the insiders of Equity Funding.

At first glance the majority and dissenting opinions appear to endorse radically different conceptions of the permissible activities of insiders and analysts who possess valuable information. The majority opinion emphatically rejects the notion, endorsed by the dissent, that obtaining a private benefit from possession of valuable information is unlawful or objectionable. As the majority correctly noted, denying those with valuable information the ability to profit on it would "have an inhibiting influence on the role of market analysts which the SEC itself recognizes is necessary to the preservation of a healthy market." More generally, market participants must have an incentive to gather and analyze information for capital markets to exist. The majority, unlike the dissent, recognized this central principle.

Despite this fundamental difference, the majority and dissenting opinions have much in common. Both agree, for example, that trading by insiders on the basis of insider information is a breach of

9. Id. at 673 (Blackmun, J., dissenting) (footnote omitted).
10. Id. at 671 (Blackmun, J., dissenting).
11. Id. at 670 (Blackmun, J., dissenting).
12. Id. at 677 (Blackmun, J., dissenting).
13. Id. at 658 (footnote omitted).
fiduciary duty. And each opinion assumes that both analysts and insiders act illegally in most cases if valuable information is communicated to analysts, who in turn disseminate it to their clients. The insider breaches his fiduciary duty by communicating the information to analysts; the analyst who does not abstain from using the information is a participant after the fact in the insider's breach.

One other feature common to both opinions is a disregard for principles of economics. Although the majority opinion refers to the salutary role of investment analysts in the operation of capital markets, much of its analysis reflects a lack of understanding of the implications of this principle. Nor does either opinion discuss other relevant concepts, such as agency costs and the role of insider trading as a compensation device. Indeed, the only explicit reference to principles of economics was in Justice Blackmun's dissenting opinion, and then only to point out that they are irrelevant, "extreme" and inconsistent with "the existence of any enforceable principle of fairness between market participants."  

Notwithstanding this disregard for principles of economics, questions such as the effect of insider trading on a firm's investors and the role of analysts in communicating information to market participants are economic, not legal questions. It is impossible to formulate rational legal rules governing those situations without some understanding of the economic consequences of different kinds of actions. Without such an understanding, legal analysis is reduced to a vacuous recitation of cliches and talismanic phrases devoid of analytical content. If insider trading is beneficial to investors because it increases their wealth, for example, it would be irrational to interpret the fiduciary duty owed to investors, the supposed beneficiaries of fiduciary duties, as prohibiting the practice.

This essay provides what the opinions in Dirks lack: an analysis of the issues presented in light of relevant principles of economics. Part I discusses the relationship between the fiduciary duty of corporate managers and insider trading. Because there is no evidence that trading by insiders systematically harms shareholders, I conclude that we should not equate the existence of fiduciary duties with a prohibition against insider trading. Part I goes on to analyze whether insiders of Equity Funding breached their fiduciary duty to the firm's current investors by revealing information that resulted in a

Part II focuses on the role of investment analysts. These market professionals create social benefits by reducing problems of asymmetric information faced by competing sellers of securities and by monitoring the actions of corporate managers. They may also provide private benefits to investors who rely on their recommendations in an attempt to earn abnormal positive returns. Because of these social and private benefits, I argue, legal rules should act to increase, not decrease, the private returns of information acquisition, and analysts should be free of legal rules restricting the use of inside information.

I. INSIDER TRADING AND FIDUCIARY DUTIES

In *Dirks* the Court reaffirmed the rule established in the earlier decision of *Chiarella v. United States*\(^\text{15}\) that the obligation to abstain from using valuable information, absent public disclosure, rests on the existence of a fiduciary relationship between the party using the information and the firm’s shareholders. Parties such as Dirks who receive information from insiders — “tippees” — also have a duty to abstain if the insider’s “tip” constituted a breach of fiduciary duty. What the Court failed to discuss, however, was why insider trading is inconsistent with the fiduciary duty of corporate managers. Analysis of this question requires an understanding of the meaning of fiduciary duties as well as the effect of trading on inside information.

A. The Meaning of Fiduciary Duties

Corporate managers are agents whose function is to maximize the value of the firm. Because they are agents, there inevitably will be some divergence of interest between their interests and investors’ presumptive goal of wealth maximization. Competitive labor, product and capital markets, as well as the market for corporate control, act to limit this divergence of interest. But because these markets do not operate costlessly — they all require costly monitoring — they limit, but do not eliminate, agency costs.\(^\text{16}\) Explicit contracts governing the employment relationship may also reduce agency costs. Again, however, such contracts are costly to negotiate and enforce, and thus agency costs are likely to remain positive. Similarly, direct


monitoring of managers' actions, either by shareholders themselves or by professional monitors such as independent directors, is an additional, albeit imperfect, method of reducing agency costs.

Fiduciary duties imposed by law are yet another method of reducing agency costs.17 Acting as implied contractual terms in agency agreements, these provisions of law allow the parties to avoid the costs of writing lengthy and detailed contracts, thereby reducing the cost of contracting. The utility of fiduciary duties, however, like that of all implied contractual terms, depends on whether the implied terms remain consistent with the intent of the parties. The question, in other words, is whether the terms implied by law would have resulted from bargaining if the costs of contracting were zero.

In the corporate context people create agency relationships to increase the value of the firm. The imposition of fiduciary duties on corporate managers will contribute to this objective if agency costs are reduced, all other things being equal. But all other things are not always equal. A rule of fiduciary duty that had the effect of preventing $100 of beneficial conduct for every $50 reduction in agency costs, for example, would not be a desirable rule. Investors would not contract for such a rule because they would be worse off as a result. If the gains from certain conduct outweigh any increased agency costs, in other words, it would be perverse to interpret fiduciary duties to prohibit the behavior because the beneficiaries of such duties, the investors, would be the losers.

B. Insider Trading and Fiduciary Duties

This analysis suggests that we should analyze the issue of whether trading by corporate managers on inside information is consistent with their fiduciary duties by reference to the effect of such trading on investors’ wealth. If insider trading increases investors’ wealth, then investors would not contract to prohibit the practice and would receive no benefit from a prohibition implied by law.

If corporate managers are allowed to trade on the basis of inside information, shareholders’ wealth might increase for two reasons. First, managers might possess increased incentives to create valuable information, and thereby increase the value of the firm, if they are allowed to profit by trading. Second, insider trading may provide firms with a valuable additional mechanism for communicating in-

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17. For a discussion of the function of fiduciary duties in the context of transfers of control, see Easterbrook & Fischel, Corporate Control Transactions, 91 Yale L.J. 698 (1982).
formation to the market. An inevitable problem in all principal-agent relationships is that of designing a compensation scheme that minimizes divergence of interest. If it were possible to observe the effort and output of individual managers costlessly, it would be possible to limit agency costs by continual renegotiations of compensation packages. Those managers who work hard and perform well would be rewarded; those who shirk and perform poorly would be penalized.

It is difficult, however, to monitor effort and output accurately. Because managers commonly work in teams, it is difficult to isolate the productivity and contribution of any one manager. The rational manager will reason that other team members will share the benefits of good performance and will bear some of the costs of bad performance. This recognition by individual managers, that they will neither capture all of the benefits of superior performance nor bear all costs of inferior performance, decreases their incentives to work hard. Moreover, renegotiations themselves are costly, so firms have incentives to conserve on their use; unfortunately, reducing the number of negotiations increases the managers' incentive to shirk and thus exacerbates the principal-agent problem.

The ability to trade on the basis of valuable information is one partial solution to this principal-agent problem. Imagine the situation of a manager who thinks that he has a good idea that will increase the firm's value. If insider trading is prohibited, his incentive to develop the idea and convince others to pursue it is the hope that he, not other members of the team, will receive a reward at the time of his next salary review. If insider trading is permitted, in contrast, the manager can immediately "renegotiate" his compensation package by purchasing shares. Because the reward is more certain, the manager's incentive to develop the valuable information and increase the firm's value is greater if insider trading is permitted. Indeed, insider trading is the only compensation scheme that allows immediate and costless renegotiation whenever managers believe that they have the opportunity to develop valuable information.

18. These two explanations of why insider trading might be beneficial are discussed more fully in Carlton & Fischel, The Regulation of Insider Trading, 35 STAN. L. REV. 857 (1983).
19. Similarly, structuring compensation packages with insider trading might allow firms to attract managers who will work hard and not be overly risk averse in their choice of investment projects. See Carlton & Fischel, supra note 18, at 871-72.
A second reason why investors may benefit from insider trading is that it gives firms an additional method for communicating information. A firm, the lowest cost producer of information about itself, has strong incentives to have its stock prices reflect information about the firm.\textsuperscript{21} The more informative the firm’s stock price, for example, the lower the incentive of investors to expend resources on wasteful search in an attempt to identify mispriced securities. This reduction in investors’ search costs will increase the net returns on investment and cause shares to trade at a higher price.

One method for the firm to provide information to the market is simply to disclose it. There is a serious moral hazard associated with disclosure, however, because low-quality firms can copy this disclosure strategy and thus investors may not pay any attention to disclosed information.\textsuperscript{22} Alternatively, disclosure of the information may cause it to lose its value, as would be the case, for example, if a firm disclosed the details of a promising new technology to competitors. In situations in which disclosure is likely to be ineffective, insider trading gives firms an additional method of communicating information. Because other market participants can observe trading by insiders, albeit imperfectly, prices will move in the direction that the new information implies. Thus share prices will reflect more information in markets in which insider trading is permitted than in markets in which it is prohibited.

These two aspects of insider trading — the increased incentive to produce valuable information and the additional mechanism for communicating information — are powerful reasons why courts should not interpret fiduciary duties to prohibit the practice. To be sure, these are not the only effects of insider trading. Critics have identified a wide array of potential perverse incentives that the use of insider trading as a compensation scheme might create. They have argued, for example, that the practice gives managers incentives to reduce the value of the firm, to undertake risky projects, to delay public disclosures, or to slow the transmission of information within the firm. The criticisms, and the responses to them, have been exten-

\textsuperscript{21} Firms do not have perfect incentives to disclose information about themselves. Disclosures by one firm, for example, are valuable to investors of other firms who do not bear the costs of disclosure. Information thus might be underproduced. This is one rationale for a mandatory disclosure system. See Easterbrook & Fischel, \textit{Mandatory Disclosure and the Protection of Investors}, 70 VA. L. REV. 669 (1984).

\textsuperscript{22} One efficiency justification for antifraud rules is that they reduce this moral hazard problem. See Easterbrook & Fischel, \textit{supra} note 21.
sively discussed elsewhere, and no point would be served by summarizing this literature here. Two points, however, should be made.

First, there are equally plausible counter-arguments to many of the arguments that the critics of insider trading offer. Thus the argument that insider trading is detrimental because it causes managers to accept risky projects can be met with the reverse argument: insider trading may be an efficient compensation scheme because it tends to reduce the agency costs associated with the investment policies of risk-averse corporate managers who are unable to diversify. The risk aversion of corporate managers might also explain why shareholders' welfare increases if insiders may profit on bad news as well as good. If insiders can benefit from investment decisions that are optimal \textit{ex ante}, even if they turn out poorly \textit{ex post}, then their incentive to make investment decisions for the purpose of increasing the value of the firm, as opposed to avoiding bad outcomes, is increased. Similarly, insider trading might accelerate disclosure because managers will only be able to profit if stock prices adjust to new information. When direct disclosure is impossible, insider trading might lead to information being impounded in price where it otherwise would not. And insider trading also might increase the flow of information within the firm if higher managers can profit by receiving valuable information before it becomes publicly available.

Second, suppose the critics are correct, and insider trading does create some perverse incentives. What conclusion follows? Certainly it does not follow that insider trading is harmful to investors. The existence of costs does not prove the nonexistence of benefits or that these costs outweigh any benefits. The question, of course, is ultimately an empirical one, for which there is no obvious answer. The actions of firms and the development of common law rules, however, do shed some light on whether trading by insiders decreases shareholders' welfare.

Firms and managers have strong incentives to allocate the property right in valuable information to its highest valued user. This is a simple application of the Coase theorem. If insider trading is an inefficient compensation scheme that results in a reduction in the value of the firm, then both managers and the firm (investors) will

23. The most comprehensive discussions are found in Manne, \textit{Law Professors, supra} note 14, and Carlton & Fischel, \textit{supra} note 18.
gain by prohibiting it. Conversely, if insider trading is an efficient compensation scheme because it gives managers an incentive to increase the value of the firm and/or provides firms with an additional method for communicating valuable information, then both managers and the firm (investors) will gain by allowing it. The actions of firms thus provide valuable clues regarding the effect of insider trading on investors’ welfare.

While the issue has never been researched rigorously, it appears that firms have not tried to prohibit trading by insiders. Firms have not announced prohibitions of insider trading in their corporate charters. Both before and after federal regulation of insider trading, insiders have traded in shares and earned positive abnormal returns. In short, firms do not seem to share the perception of many academics and regulators that insider trading creates grave perils for investors. If anything, the behavior of firms suggests that insider trading may be beneficial.

Like firms, states also have incentives to adopt efficient rules of corporate law to attract incorporations. State and common law rules that have survived over time, therefore, are entitled to at least a weak presumption of efficiency. The common law rule, at least with respect to trading on organized exchanges, is that insider trading is permitted. This common law rule tends to support the proposition that insider trading is beneficial.

That insider trading may be beneficial in some situations, however, does not mean that it always will be so. If an insider’s use of information reduces the value of the information to the firm — such as where an insider purchases shares and causes the price to rise with the knowledge that the firm is about to purchase the same shares — then the trading may constitute a usurpation of a corporate opportunity. Purchase of the shares in this situation is no different from purchasing land with the knowledge that the firm intends to make the same acquisition. In addition, the incentive effect that allowing insider trading may create might be absent in some

27. Several studies are collected in Carlton & Fischel, supra note 18, at 303 n.12.
30. Cf. Brophy v. Cities Serv. Co., 31 Del. Ch. 241, 70 A.2d 5 (1949) (purchase of shares by corporate insider with knowledge that corporation was about to purchase the same shares held to be breach of fiduciary duty).
situations. Trading by those who do not develop valuable information may be inefficient, and thus the firm might want to prohibit such persons as government officials, lawyers, accountants, and printers who are informed of an impending merger from trading on the information. But while the firm might want to prohibit these persons from trading, that does not mean that it also wants to prohibit the managers or employees who developed the idea of a merger or identified potential partners. The firm, in other words, might want to prohibit some individuals, but not others, from trading on the same information.

Properly understood, therefore, the relationship between insider trading and fiduciary duties depends on whether the trading is consensual. In cases of nonconsensual trading, we should interpret fiduciary duties — standard-form terms governing agency relationships — to prohibit the practice. But not all trading on valuable information falls within this category. Firms have allowed insiders to own and trade shares, both before and after the existence of regulations, even where insiders systematically earn positive abnormal returns. In these cases of consensual trading the firm has allocated the property right in valuable information to corporate managers, and courts should no more interpret fiduciary duties to prohibit insider trading than to prohibit salary or other aspects of managers' compensation.

Courts, however, have largely ignored this crucial issue of whether trading by an insider is consensual.31 Under current law, insiders who trade and are sued by shareholders cannot raise as a defense the fact that a disinterested majority of directors approved the trading or that its possibility was negotiated explicitly as part of a compensation package.32 Conversely, trading on information stolen from the firm may not constitute insider trading in many situations.33 These results are precisely the opposite of what economic theory would predict.

31. While the Supreme Court has not explicitly enunciated a test for insider trading based on consent, some commentators argue that courts have, in effect, used such an analysis. See, e.g., Macey, From Fairness to Contract: The New Direction of the Rules Against Insider Trading, 13 Hofstra L. Rev. 9 (1984). To the extent this view is correct, the “prohibition” against insider trading may be a special case of laws against theft and therefore beneficial.


C. The Supreme Court's Interpretation of Fiduciary Duties

Having established the relationship between fiduciary duties and insider trading, we may now usefully focus more closely on the Supreme Court's analysis of the issue. Relying on the Security and Exchange Commission's famous decision in In re Cady, Roberts & Co., the Court stated that the fiduciary duty of insiders not to trade on valuable information rests on two elements: (1) "the existence of a relationship affording access to inside information intended . . . for a corporate purpose" and not for the personal benefit of anyone else; and (2) the inherent "unfairness of allowing a corporate insider to take advantage of valuable information by trading without disclosure." Neither element provides a coherent rationale for interpreting the fiduciary duty of corporate managers to prohibit insider trading.

The first justification — that insiders should not trade on the basis of valuable information that is intended solely for a corporate purpose — is tautological. If the property right in valuable information is allocated to the firm, then insiders should not be allowed to trade. It does not follow, however, that insiders should not be allowed to trade if the property right in invaluable information is not allocated to the firm. In the situation of consensual trading, nothing in managers' fiduciary duties should prevent them from trading.

The second justification — that there is an inherent unfairness in allowing managers to profit by virtue of their exclusive access to valuable information — assumes that "fairness" requires that managers and investors be treated alike. But there are obvious differences between managers and investors which warrant different treatment. Is it "inherently unfair," for example, for managers but not shareholders to receive a salary? Presumably it is not, because shareholders realize that if managers receive a salary, the value of the firm will be greater than if managers do not receive a salary. And the larger the size of the pie, the more shareholders, as well as managers, will benefit. Insider trading is not "inherently unfair" for precisely the same reason. If insider trading is part of a manager's compensation package because of its beneficial incentive and information effects, then both shareholders and managers benefit from allowing it. What the Court has failed to understand is that insider trading

need not come at the expense of investors any more than do other kinds of compensation. Because both shareholders and managers benefit from compensation schemes that increase the value of the firm, no fairness argument exists for prohibiting insider trading. On the contrary, it would be "inherently unfair" to deny shareholders the ability to enter into contracts with their agents that result in an increase in shareholders' wealth.

D. Did the Insiders of Equity Funding Violate Their Fiduciary Duties?

The Supreme Court in *Dirks* concluded that the insiders of Equity Funding did not breach their fiduciary duty by providing Dirks with information about the fraud. The Court reasoned that they "received no monetary or personal benefit for revealing Equity Funding's secrets, nor was their purpose to make a gift of valuable information to Dirks." Rather, "the tippers were motivated by a desire to expose the fraud." Because the insiders did not act with an improper purpose in giving the information to Dirks, Dirks did not act unlawfully in persuading his clients to sell.

The difficulty with the Court's analysis is that it ignores the effects of tipping on the wealth of the firm's investors. I have emphasized that we should view fiduciary duties as standard-form contractual terms that govern agency relationships. Whether a corporate manager's conduct is a breach of fiduciary duty, therefore, depends on whether the conduct promotes or frustrates investors' presumptive goal of increasing the value of the firm.

Instead of analyzing the actions of Equity Funding's insiders under this standard, the Court emphasized the insiders' role in exposing the fraud. But exposure of fraud is a public good; consumers and society as a whole benefit, but the firm's investors do not. And it is the effect of conduct on investors' wealth that should determine whether a breach of fiduciary duty has occurred. Under this test, it could be argued that the actions by Equity Funding's insiders were causally related to the company's eventual bankruptcy, to the obvious detriment of its current investors. While the news would have been discovered at some point, some of the firm's current investors would have sold at inflated prices to new investors. The disclosures caused current investors to lose the ability to sell at higher prices.

37. *Id.*
It is possible, in other words, to turn the Court’s analysis on its head. There is little question that if *Dirks* had involved an insider’s tip to analysts that the firm was about to announce record earnings, which resulted in purchase of shares by clients in advance of the announcement, the Court would have held that the insider breached his fiduciary duty and the analyst was a “participant after the fact.” Disclosure of a fraud, however, is perfectly legal. Thus disclosures that increase the value of the firm to the benefit of investors are illegal, while disclosures that cause the firm to go bankrupt are perfectly lawful. Because the Court equated the social benefit from exposing frauds with fiduciary duties, it failed to appreciate this tension.

A fundamental distinction exists, however, between the effect of rules *ex ante* and *ex post*. At the time the firm is organized, shares will sell for a higher price if the firm’s ability to defraud investors is reduced. The lower the probability of fraud, the fewer the resources that investors must spend on monitoring, and the lower the discount that investors will apply in valuing the shares. This relationship holds true even if the fraud will be perpetrated on future classes of investors. Because current investors realize they may be selling their shares at a lower price to subsequent investors who fear the market price is artificially inflated because of fraud, they will pay more for shares under a rule that restricts the firm’s ability to defraud future investors. Thus the actions of Equity Funding’s insiders were probably consistent with the organizing principles of the firm, and therefore with their fiduciary duties, even if, *ex post*, the firm’s investors would have preferred no disclosure.

An important implication of the preceding discussion is that the personal benefit test the Court used to determine whether a disclosing insider breaches a fiduciary duty is completely irrelevant. Assume, for example, that the insiders who provided Dirks with information received some kind of benefit, perhaps in the form of direct or indirect compensation, and that they did not act solely out of a desire to expose the fraud. (I am assuming that we can define “benefit.” After all, utility from exposing fraud is itself a kind of benefit.) Should the existence of compensation make a difference?

Clearly it should not. The relevant inquiry in analyzing the propriety of disclosure of information to analysts, like the inquiry with

38. *See id.*
39. This is the economic rationale of the antifraud laws. *See supra* note 21.
respect to trading itself, is whether the action is consistent with the explicit and implicit contractual terms that govern the firm. Since the actions of Equity Funding's insiders were probably consistent with the terms that would maximize the value of the firm ex ante, no violation of fiduciary duty occurred. Other kinds of disclosures to analysts, as I discuss in the next section, might also be consistent with fiduciary duties, properly understood. Of course the opposite situation can also occur. Imagine a situation where a corporate insider stands on a street corner and randomly gives away valuable corporate information to strangers who trade on it. Such conduct is clearly inconsistent with fiduciary duties even if there is no obvious personal benefit. The existence or non-existence of personal benefit sheds no light whatsoever on the propriety of tipping information.

II. THE ROLE OF INVESTMENT ANALYSTS AS INFORMATIONAL INTERMEDIARIES

Spectacular frauds are rare events, and thus Dirks is an aberration. Far more common are situations in which analysts try to provide their clients with valuable but less dramatic information. The implications of the Dirks case for the application of insider trading laws to analysts in these more routine situations will depend on future judicial interpretation. It is plausible to assume, however, that insider trading prohibitions will continue to be applied to analysts. Indeed, the Court said as much when it emphasized that the analyst's receipt and use of information from an insider who receives a direct or indirect "personal benefit" constitutes a violation of law by both the insider and the analyst. But examination of the role of the investment analyst demonstrates that there is little logic in subjecting them to insider trading laws.

A. The Sale of Securities in the Presence of Asymmetric Information

The sale of securities, either by the firm to investors or by current to future investors, can be viewed as an example of the familiar problem faced by competing sellers of goods of varying quality in the presence of asymmetric information. Unless some method exists for investors to distinguish high quality from low quality securities, they will tend to view all securities as average in quality. High quality securities will sell at prices lower than they would if information

about their quality could be transmitted costlessly; the opposite would be true for low quality securities. This process will result in a "lemons" market, in which low quality securities dominate because firms lack the incentive to offer high quality securities.\footnote{See Akerlof, The Market for "Lemons": Quality Uncertainty and the Market Mechanism, 84 Q.J. ECON. 488 (1970).}

One method for firms offering high quality securities to distinguish themselves is to disclose the information supporting their belief. But, as discussed earlier, there is a serious moral hazard problem associated with the disclosure of information because firms offering low quality securities can mimic high quality firms by disclosing the same information. In this manner firms offering low quality securities can erode the informational content of disclosure, causing investors once again to value all securities as average.

Moreover, disclosure may not always be possible. The clearest case occurs if disclosure of information would cause it to lose its value. A firm that wants to sell securities at a high price because of an anticipated technological breakthrough, for example, must have some method for convincing investors to pay a price for the securities without directly disclosing the information about the breakthrough. In the absence of such a method investors will view the securities as average, and will calculate the price they are willing to pay accordingly.

Firms have developed a wide array of tools for overcoming this problem of asymmetric information. Dividend policy, capital structure, and the percentage of shares owned by insiders are all mechanisms through which high quality firms can attempt to distinguish themselves from low quality firms. Sale of securities through investment bankers and reliance on independent accountants to verify financial statements are other methods for achieving this same objective.\footnote{These mechanisms for disseminating information are discussed in more detail in Easterbrook & Fischel, supra note 17.} Allowing insiders to trade also enables the firm to communicate information to investors indirectly, and insider trading may also make direct disclosures more credible. An announcement that increased earnings are expected is likely to be more credible if coupled with a disclosure that insiders have increased their stake in the firm.

Dissemination of information to investment analysts is yet another method for reducing the problem of asymmetric information. This kind of selective dissemination has several advantages over pub-
lic disclosure. First, it may be cheaper than public disclosure because there are likely to be economies of scale in interpreting and verifying information. Second, the moral hazard problem is reduced. Unlike many firms that may resort to capital markets infrequently, investment analysts are repeat players who have a strong interest in maintaining a reputation for honesty. Because investors realize that analysts have this reputational interest, they will give analysts' recommendations more weight than disclosures by the firm alone. In addition, selective disclosure to analysts may also allow firms to communicate valuable information that they could not disclose publicly. Recall the firm that anticipates a technological breakthrough and thus want to sell its securities at a high price without disclosing the details to competitors. By selective disclosure to analysts who then recommend purchase to their clients, the firm can communicate the essence of the information without giving away valuable information to competitors. Finally, selective disclosure to analysts enables firms to communicate information about quality with less risk of suit than if the information were publicly disclosed.

Selective disclosure to analysts is not a perfect solution to the problem of asymmetric information. Analysts may disclose the underlying information to investors, for example, or sell it to competitors. For these reasons, firms may refuse to disclose some information to analysts or limit their disclosures to analysts with strong reputational credentials. In spite of these constraints, it is plausible to assume that the use of analysts will facilitate the transmission of information.

Analysts serve a monitoring function as well as providing a conduit for the transmission of information. Because managers may disseminate false information about the firm, or may attempt to conceal negative information, analysts have incentives to engage in some search themselves before making recommendations to their clients. This monitoring activity is a natural complement to the role of analysts in communicating information about the firm to investors.

The use of analysts benefits firms and investors alike. They enable firms to communicate information more cheaply than if all information had to be publicly disclosed, and because analysts have a comparative advantage over investors in interpreting, verifying and seeking out information, investors will engage in less wasteful search if they can rely on analysts' recommendations.
B. Why Investors Hire Analysts

One question that has long puzzled financial economists is whether the information possessed by analysts and other professional investors can produce superior risk-adjusted portfolio returns, after transaction costs, compared to those available from a simple buy and hold strategy. The early efficient markets literature answered this question in the negative. This early literature claimed that capital markets are so efficient, precisely because of the efforts of professional investors to identify mispriced securities, that these same professional investors could not systematically possess information that stock prices did not fully reflect. This claim, however, led to a disturbing paradox. If market professionals cannot earn superior portfolio returns, they lack any incentive to expend resources to discover mispriced securities. And if investors do no better following analysts’ recommendations than they do with a buy and hold strategy, then why are they willing to pay for advice that is, by hypothesis, worthless? The early efficient markets literature, in sum, placed great weight on the role of market professionals in explaining market efficiency, but offered no explanation for why these professionals or their clients are willing to engage in this effort.

More recent developments in the efficient markets literature have addressed this seeming paradox. In an important series of articles Sanford Grossman has argued that markets cannot be “efficient” in the sense that prices fully reflect all information. Rather, some information must not be reflected in stock prices to ensure that informed traders earn a competitive return for search, in terms of trading profits, from possession of superior information. Under the Grossman model, in other words, the efficiency paradox disappears: analysts are willing to engage in search, and investors are willing to pay for their recommendations.

Whether professional investors can earn superior returns, as the Grossman model predicts, or not, as the early efficient markets liter-
nature predicts, is, of course, an empirical question. While no definitive answer currently exists, recent empirical findings, often without saying so explicitly, tend to support the Grossman model. Under this view the explanation for hiring analysts is simple — to obtain superior information and earn abnormal positive returns.

C. The Effect of Applying Insider Trading Laws to Analysts

The obvious effect of applying insider trading laws to investment analysts is to raise the cost to both firms and investors of using analysts to communicate valuable information. This result has important implications for the actions of firms, analysts and investors. If legal rules place a “tax” on the use of analysts, then firms will use other method of communicating information. It is difficult to know precisely what method they will use. They may increase the amount of public disclosure. Alternatively, they may increase the amount of debt in their capital structure or increase the percentage of shares owned by insiders.

The difficulty with forcing firms to use other methods of communicating information is that those methods may be more costly. That firms voluntarily transmit information to analysts suggests that the use of analysts is an efficient method of communicating information. Increasing public disclosure, by contrast, may subject the firm to possible legal liability and cause public investors to incur needless interpretation and verification costs. Similarly, increasing the amount of debt in the firm’s capital structure may help to distinguish high quality firms but also increase potential bankruptcy costs; enlarging the percentage of shares owned by insiders also may communicate information about quality but at the cost of requiring insiders to bear more risk, for which they must be compensated. Making it more difficult for firms to use one mechanism of transmitting information will cause them to rely on higher cost substitutes.

From the perspective of analysts, the conclusion is similar. Analysts, according to current legal rules, may search for information themselves and analyze publicly available information, but they may not receive “inside” information unless they publicly disclose it. Public disclosure, of course, is not a realistic possibility, because it will

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cause the information to lose its value. Nobody will pay an analyst for information that he must publicly disclose before selling it to his clients. Firms might not communicate information to analysts, moreover, if analysts must disclose it, since the desire to avoid disclosure might be the firm’s reason for using an intermediary.

In practical terms, then, legal rules try to deny analysts access to the most efficient source of information: the firm itself. It is irrelevant whether the firm wants the analyst to have the information. Legal rules require the analyst to engage in costly search in an attempt to duplicate the information that the firm would have provided voluntarily. Just as insider trading laws have the effect of forcing firms to utilize more costly methods of communicating information, they also have the effect of forcing analysts to use more costly methods of acquiring information.

This effect of making the process of transmitting information more costly operates to the detriment of investors, the supposed beneficiaries of insider trading laws. Application of such laws does not eliminate the problem of asymmetric information; rather, the effect is to make it more difficult (costly) to reduce the informational disparity. Investors will have to pay more to obtain the same information. Alternatively, they may engage in wasteful search themselves, to distinguish between high and low quality firms. These are real cash outflows that will decrease the net return on investment.

The magnitude of this effect is difficult to predict. It depends on such variables as the efficiency of insider trading laws in deterring the transmission of information and how close other methods of communicating information are as substitutes for use of analysts. It may be, for example, that because of the materiality requirement, legal rules have only a minimal deterrent effect. Similarly, the increased costs that the use of other methods of communicating information impose may be trivial. The relevant conclusion, however, is that any increased costs that investors incur in obtaining information about firms makes them worse off.

D. Fairness

The proponents of insider trading laws might concede everything up to this point and argue that it is all irrelevant. After all, the

47. The materiality requirement prohibits trading based on “important” information such as knowledge of an impending merger. It does not prohibit trading whenever there is asymmetric information. Nor does it prohibit a decision not to trade based on asymmetric information, no matter how “material.”
discussions concerning the legal prohibition against insider trading have never focused on efficient methods of compensating corporate managers or of communicating information to investors. Rather, the focus has been on considerations of fairness, particularly the perceived unfairness of one group of investors having access to valuable information in advance of others.

At least in the context of investment analysts, however, this is a very strange notion of fairness. We can view the hiring of an analyst as the purchase of superior product-information. Other market participants may decline to purchase superior information and simply accept the market price as given. They earn lower returns, but they also save the costs of becoming informed. Neither group of participants is better off than the other.48

By what theory of fairness are these two classes of investors, one that has paid for superior information and one that has not, entitled to equal treatment? A more intuitively compelling theory of fairness would treat these two classes of investors differently rather than allowing those who are free riders to obtain the same benefit from information as those who pay for it. If using analysts is an efficient method for the firm to communicate information, then no plausible theory of fairness prohibits their use.

CONCLUSION

The Supreme Court’s decision in Dirks v. SEC, recognizing that analysts like Raymond Dirks cannot function if they must publicly disclose valuable information, represents a small step forward. Unfortunately, the Court did not appreciate the full implications of this principle. The decision suggests that absent a motivation to expose corporate fraud, analysts who convey valuable information to their clients act illegally. Such a legal rule reflects a lack of understanding of the beneficial role of investment analysts as informational intermediaries.

48. For a fuller discussion of these two classes of investors, and the implications for securities regulation, see Fischel, Use of Modern Finance Theory in Securities Fraud Cases Involving Actively Traded Securities, 38 Bus. L. 1 (1982).