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Saul Levmore

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IN DEFENSE OF THE REGULATION OF INSIDER TRADING

SAUL LEVMORE*

The regulation of insider trading—transactions in the securities of a firm by persons possessing special information that is derived from their advisory or fiduciary relationship or their employment with the firm—has had strong support among those who look to noneconomic values to determine the proper role of government and the ideal content of laws in our society, but it has had much weaker support among observers who identify with the law-and-economics movement. In this essay, I argue that there is little reason to think that unregulated insider trading is a good thing. These comments stress the economic dangers of insider trading and indicate, in passing, that these dangers are related to those that underlie—but that are also insufficiently recognized in—the case for *not* regulating the behavior of managers seeking to thwart tender offers.

Part I of these comments compares the "disclose-or-abstain" scheme, the current strategy of our federal laws for regulating insider trading, with other schemes, including deregulation. Part II focuses on insider trading and mergers.

I.

The starting point in assessing different strategies for dealing with insider trading is a framework—adopted by many commentators today, but advocated by Henry Manne alone some years ago—that recognizes both the value of information and the importance of protecting property rights. In the settings that raise the question of the proper regulation of insider trading, these two goods, information and property rights, are frequently forced into competition with one another. A legal system that stressed the value of information might, for instance, encourage or force all businesses to disclose information about future plans and projects. After all, when such information is withheld, neighbors, customers, suppliers, investors, and competitors are likely to make suboptimal decisions. It is obvious, however, that this sort of full disclosure, while

* Professor of Law, University of Virginia.

promoting efficient behavior on the part of persons and entities affected by the actions of the disclosing business, can be harmful to the interests of the discloser. A firm that disclosed all its future plans would find, for example, that it faced higher prices when dealing with informed, strategic suppliers who controlled assets of special importance to the firm's plans. Quite clearly, the value of a firm's plans, or property in general, decreases if the firm must reveal these plans at a time that is premature in terms of minimizing the cost of putting such plans into effect. Thus, it appears clear that rules requiring the disclosure of information may interfere with property rights.

The converse proposition—that full protection of property rights may lead to too little information and to inefficient behavior—is even easier to grasp. If, for example, a firm withholds information about its plan to provide train service between points A and B (perhaps because it fears that disclosure will cause an increase in the price of land needed for this rail link), then other businesses may make suboptimal locational decisions (to set up in location C, for instance) that can only be corrected at great expense once they learn about train service between A and B.

I have pointed out elsewhere that a legal system can try to resolve this tension and have the advantages of both full information and property right protection by requiring disclosure while endowing firms with eminent-domain-like powers to offset the strategic responses of those with whom they deal.[1] Such a scheme, however, creates different costs to the extent that eminent domain is itself a costly and imperfect process.[2] I do not wish to argue for such a scheme, but rather only to set in proper perspective our current insider trading laws. The current "disclose-or- abstain" regime, requiring insiders to refrain

1. Levmore, *Securities and Secrets: Insider Trading and the Law of Contracts*, 68 VA. L. REV. 117, 126-28, 142-44 (1982).

2. A useful way to think about this point is to note that the government has more trouble keeping its plans secret than private enterprises do, if only because the government tends to hold hearings and votes on the details of its plans, but the government is then able to use its takings power to overcome the disadvantages of openness. Thus, when the government plans to construct a highway, in the absence of eminent domain some landowners would hold out for high prices for their well-located property (and these holdouts might even put an end to the highway plan). Similarly, the law could require more disclosure of all businesses, in order to improve the information flow in the economy, but then arm the disclosers with the power to condemn property (at predisclosure prices). Inasmuch as eminent domain is a less than perfect process, it is not surprising that our legal system does not choose this path. *See id.* at 142-44, 152-54.

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from trading if they have an informational advantage, needs to be contrasted not only with a "free market" regime, but also with a "full information" scheme. Under full information rules, there would be more disclosure, and hence more efficient decisions made by those affected by this information, than under the present "disclose-or-abstain" rules, and there would be much more information than in a completely unregulated, "free-market" system. My intuition—since there are no data measuring the costs of disclosure or nondisclosure—is that the current "disclose-or-abstain" regime is a decent compromise between a completely unregulated approach that would suppress valuable information, and a more regulatory approach that would strive for full disclosure with some "private eminent domain." Because the attacks on the current substantive rules are mostly from the deregulation flank, I turn now to specific efficiency-based arguments against complete deregulation.

It is useful to note first that under rules allowing insiders to trade on inside information, information will be disclosed more slowly than under the disclose-or-abstain rules presently in effect. After all, if insiders, who are able to decide when to disclose information about a firm's plans, can profit from trading, when in fact they know more about the firm's future than do outsiders to whom they will sell securities or from whom they will purchase securities, it stands to reason that these insiders will hold on to their advantage longer than they will if they are not allowed to profit from the inside information. An insider who knows that valuable mineral properties have been discovered will withhold this information, not only to give the firm time to sign contacts before those with whom it deals know enough to change their strategy, but also to give himself time to trade profitably on the information.[3] To the extent that suppliers, customers, outside investors, and others will then be ignorant for longer periods of time, they will make more inefficient decisions. In short, decisions made by outsiders that are contingent in some way on information possessed by insid-

3. The essential point is that information about a firm's plans has a social value that exceeds the private value to the firm. The firm will, therefore, have less interest in encouraging its employees to disclose sooner rather than later than will the society have in receiving this information. To the extent that the firm must worry that employees will misbehave in order to profit from *bad* news, *see infra* text preceding note 4, it will have an incentive to discourage the withholding of information. The firm's efforts in this regard can hardly be perfect and, in any event, need not carry over to good news.

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ers will be made more efficiently in the present "disclose-or-abstain" world than in an unregulated, free-market world.

A second reason to think that some regulation of insider trading is better than none is apparent once one considers that an insider can also profit from advance knowledge of a price *decrease* by selling short in advance of the publication of the information. It is almost paradoxical that the moral hazard associated with this means of profiting—that an insider will actually *cause* a loss so that a price decrease that he can profit from will occur—is readily ignored by most proponents of deregulation. After all, the argument most frequently advanced in favor of deregulation is that insider trading offers an important and desirable incentive for those agents who run a firm to increase its value. Presumably, agents will work hard and cleverly, and since they will know that they have done so, they will trade successfully in the firm's securities. This ability to trade profitably will, in turn, cause them to work harder and more cleverly. This argument requires a belief that other possible incentives that shareholders (and markets) might offer their agents, including stock options, explicit bonuses, promotions, and lateral job opportunities, are not adequate substitutes for insider trading. This claim is unpersuasive, because it appears that all the positive incentive qualities of insider trading can in fact be matched by other tools—and these other tools, such as stock options, are explicit and calculable by employers, or shareholders, and are therefore preferable to insider trading. Indeed, I think it no surprise that we do not regularly see corporations *granting* managers the right to trade on inside information, and attempting through this grant to overcome the 1934 Securities Exchange Act.[4]

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,

4. 15 U.S.C. §§ 77b-77e, 77j-77k, 77m, 77o, 77s, 78a- 78kk (1982 & Supp. III 1985). A popular contemporary question is whether it would be a violation of the federal securities laws if an insider traded in the employer's stock after being permitted explicitly by his employer to trade on inside information. It has been noted that we have no historical example of a firm forbidding (or trying to forbid) insider trading, although it would have been possible to legislate the content of the 1934 Securities Act in this private way. *See* Dooley, *Enforcement of Insider Trading Restrictions*, 66 VA. L. REV. 1 (1980). The point in the text is to argue that if firms' failure to contract out of the unregulated scheme (especially before 1934) proves something then so does the modern failure to contract out of the "disclose-or-abstain" regulatory pattern.

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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. An insider might ruin a promising research project or overlook fraud by a subordinate simply to profit from the later, inevitable downturn in the firm's value. It is inconsistent to insist that insiders will not behave badly in order to profit from downturns that they know about ahead of the market because other market forces, such as their reputational interests, will make such negative behavior not worthwhile, while arguing that similar market forces do not adequately reward good work.

In short, deregulation 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.[5]

II.

The second point developed in Part I, that we must worry

5. I do not mean to insist that regulation is always the norm and that deregulators must prove their case beyond any doubt. Deregulation involves a weakening of property rights (possessed by all the owners of each firm), and I think it fair to argue that those who would eliminate these evolved property rights bear the burden of proof, much as we would require convincing arguments before we made shoplifting legal. The fact that most people would explain shoplifting rules as simply "fair" to shopkeepers hardly diminishes the strong economic arguments which suggest that virtually everyone is better off with a rule protecting property rights (and avoiding the waste of resources that would be used in guarding goods from shoplifters.)

At the symposium at which a version of this paper was presented, Judge Douglas Ginsburg asked those who would completely deregulate insider trading a pointed and pedagogically useful question: "Would you also allow judges or government officials to trade on the basis of information about the way in which they know they will decide matters (that are as yet unpublicized)?" Note that there is *less* of a moral hazard (at least for judges) than in the case of corporate insiders because, while the latter might prefer that their company do poorly (after selling short, for instance), judges could often profit from a decision in favor of either party.

If there is a response from the deregulation camp to the question implicit within this question, it is presumably that judges will not be better motivated to work harder or better by the profit potential of insider trading, so that nothing is gained by such deregulation and something is lost if they will be tempted to expand their jurisdiction or the variability of their decisions. In the case of other government officials, there is arguably a serious moral hazard that compels us to forbid such trading. An official who makes zoning decisions, for instance, might make inefficient decisions in order to profit from increases in certain property values. However, this is precisely the problem with insider trading by corporate insiders. I would be interested to know how proponents of deregulation would answer the question about "insider" trading by judges and other government employees.

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about encouraging inefficient behavior, can be made with regard to many legal questions. Consider, for example, one area of law not very different from the regulation of insider trading by corporate managers and directors—the regulation of "going private" transactions in which insiders buy out public shareholders. If we can ignore both the borrowing that often distinguishes these transactions from other forms of insider trading and the tax laws that may have motivated them,[6] it is possible to focus on the question of whether such structural changes are likely to be efficient (as, one presumes, most voluntary transactions are), or whether there is reason to be concerned about inefficient transactions. The usual arguments for and against such transactions simply extend the insider trading debate; on the one hand, after the firm "goes private," the managers will own all the equity in the firm, and may, therefore, work harder. On the other hand, these managers may have waited until they developed information that good fortune was around the corner before booting the public shareholders whose funds helped develop this information and employ these managers in the first place.[7] "Going private" is, after all, simply a huge trade by insiders.

If we focus, however, on the possibility that a moral hazard may generate *inefficient* behavior, a different concern about "going private" transactions materializes. Imagine a firm that is currently selling at $10 per share. Its managers know of two distinct plans for its future. The first involves combining with any of three or four other firms in a related business, and the second involves developing some research proposals that have been worked on internally and secretly. Imagine that the first plan would cause the firm's value to rise to $20 per share, so that one of these three or four potential acquirers is expected to try to acquire the firm for a price between $10 and $20, and the second plan would cause its price to rise to $15. Even if "going private" will cause the potential acquirers to lose interest (perhaps because they would need to give the target's managers too large a stake in the surviving enterprise), and even if the insiders must pay a premium to go private, the insiders will often prefer the less efficient, less valuable second plan because

6. *See* Levmore, *The Positive Role of Tax Law in Corporate and Capital Markets*, 12 J. CORP. LAW 483 (1987).
7. *See* R. CLARK, CORPORATE LAW 507 (1986).

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they get 100% of its profits, while they would often have to share the value of the outside offer with other shareholders. Plainly, 100% of X can be worth more than less-than-100% of an amount greater than X.[8]

This example prompts both a general and a specific point. The general point is that while deregulation of merger law is a terribly important topic for public education and law reform, little is gained by defending insider trading that occurs around the time of tender offers as necessary to promote efficient takeovers. It may or may not be true that the Williams Act[9] and various state laws interfere excessively with the market for corporate control[10]; target shareholders encounter coordination problems that may be overcome only by rules and techniques that unfortunately allow selfish target managers to ward off those who would efficiently replace them. But these questions and tensions need to be confronted directly, not through claims that insider trading *beneficially* allows an acquirer to escape the Williams Act and accumulate sufficient numbers of shares to take over a hostile target. As we have seen, such insider sales of stock can just as well lead to inefficient behavior. It is even possible that insiders will favor a merger that is profitable to an acquirer but *not* to the target, simply as a means of profiting from the sale of shares to the acquirer.

The specific point that is related to the idea that inside traders may prefer less efficient changes to more efficient mergers concerns the scope of Rule 10b-5 of the 1934 Securities Act.[11] Can an employee of an *acquirer* trade in the target company's

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8. Imagine that the insiders own 39 of 100 outstanding shares and that these shares trade at $10. If they can "go private" by buying the remaining 61 shares at an average price of $12 (this example will work if they can buy up these shares at an average price of less than $15.35), then when the value rises to $15, their overall profit will be $(39 \times 5) + (61 \times 3) = \$378$. If, on the other hand, an outside acquirer will pay $16 for all the firm's shares, the insiders will only receive $39 \times 6 = \$234$.

9. 15 U.S.C. §§ 78*l*-78n (1982 & Supp. III 1985).

10. Disclosure and other legal obligations of the acquirer may interfere with efficient acquisitions. On the other hand, the coordination problems experienced by dispersed target shareholders *and* the advantage, which I believe normally accrues to the first bidder in an auction where information is expensive, may call for legal rules that interfere with the first bidder's, or acquirer's, maneuvers. These matters are beyond the scope of this discussion.

11. 17 C.F.R. § 240.10b-5 (1986). Rule 10b-5 states:

> It shall be unlawful for any person, directly or indirectly, by use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a

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stock on the basis of inside information? Inasmuch as recent decisions in this area have focused on the duty owed by the trader to the company whose securities are traded, there is every reason to think that this question will be answered in the affirmative. The acquirer's employee would seem to violate Rule 10b-5 only by trading in the acquirer's stock and not in the target's stock.[12] A moment's reflection on the moral hazards associated with insider trading suggests, however, that it might be useful to use the existing securities laws to bar trading by those who owe a duty to the target or to the acquirer. After all, just as a target's insiders can profit through insider trading by encouraging inefficient mergers (and downturns in the target's performance in general), so too can the acquirer's insiders profit by influencing their firm in the direction of inefficient transactions. The core problem is the ability to profit from control over bad news or inferior mergers, and it would seem that this can be done from either side of a merger.

CONCLUSION

I have stressed two points. First, information matters a great deal, and there is likely to be *less* of it in an unregulated world where it can be withheld with impunity. Second, we need to think about the moral hazard of insiders' creating bad news. The best known examples of insider trading concern mineral discoveries and other items of good news. These examples have skewed our thinking so that there is a tendency to overemphasize the positive effect of insider trading on security prices and work effort, and underemphasize the moral hazard that the potential profit from insider trading will itself be the cause of bad news.

It is too easy these days to think of all deregulation as promoting free enterprise and all that is good. The real world is

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material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

12. The trader is normally held to be liable only if he or she (or a "tipper") has some link (or "duty") to the traded company. *See* Chiarella v. United States, 445 U.S. 222 (1980); Dirks v. SEC, 463 U.S. 646 (1983). An acquiring company's employee would seem to have no duty to the target company. Although the *acquirer* may not appreciate its employee's trading in the target's stock, since this might cause a price rise that would make the acquirer's plan more costly, the acquirer has not been thought to have a securities-law-based claim on these facts.

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more complicated. Many things, like shoplifting and insider trading, are illegal for good economic reasons. We must be sure we understand the economic arguments in favor of regulation before we rush to assume that economic regulation of insider trading is generated by half-baked ideas about what is "fair," and that the insider trading laws must all be dismantled.

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