1987

Signalling and Causation in Insider Trading

William J. Carney

Follow this and additional works at: https://scholarship.law.edu/lawreview

Recommended Citation
SIGNALLING AND CAUSATION IN INSIDER TRADING

William J. Carney*

The multiple meanings of causation, the divergent views on the required intensity of causation, the differing patterns of stock ownership and relief sought, all combine to make this the most confusing of all confusing areas.**

Revelations of major insider trading cases during 1986 have led to charges that major participants in the financial markets have failed to act responsibly, and to pleas for further regulation, both of insider trading and of the market for corporate control.1 This Article will examine the nature of the harm alleged to occur in insider trading, and will conclude that little harm can be demonstrated to particular investors, to markets generally, to issuers, or to bidders. While insider trading has long been unlawful under the federal securities laws, there has been little examination of who is harmed by insider trading.2 The purpose of this Article is to explore that issue. No

* Charles Howard Candler Professor, Emory University Law School. I wish to acknowledge the assistance of John W. Spotts, Emory Law School, 1987. Thanks are also due to Professors Fred S. McChesney of Emory, Jonathan R. Macey of Cornell, Dean Henry G. Manne of George Mason and William K.S. Wang of Hastings for their helpful comments on earlier drafts of this Article. I also acknowledge the helpful conversations that occurred at a Liberty Fund Colloquium on Insider Trading, held under the auspices of the Emory Law & Economics Center, in May 1985, which generated the ideas found in this Article. I am, of course, solely responsible for the errors that may remain.

** 2 A. Bromberg & L. Lowenberg, Securities Fraud and Commodities Fraud § 4.7(551), at 86 (1985).

1. Dennis Levine was accused and later pleaded guilty to trading on confidential information about takeovers. Drexel Official Accused by SEC of Inside Trades, Wall St. J., May 13, 1986, at 3, col. 1; Fallen Star: How Inside Knowledge Made, Ruined Career of Dennis B. Levine, Wall St. J., May 15, 1986, at 1, col. 5. Arbitrageur Ivan Boesky was later accused of having dealt with Levine to secure the same information. Big Trader to Pay U.S. $100 Million for Insider Abuses, N.Y. Times, Nov. 15, 1986, at 1, col. 6; Legend Turned Inside Trader: Boesky Touch Seemed Magic, N.Y. Times, Nov. 15, 1986, at 37, col. 3; see also A Wall St. Lawyer Admits Insider Guilt, N.Y. Times, Nov. 27, 1986, at D4, col. 1 (describing a ring including an associate in a Wall Street law firm who passed information on to four other persons, including an arbitrage analyst at Marcus Schloss & Co., and analysts at Drexel Burnham Lambert Inc. and Mosely, Hallgarten, Estabrook & Weeden Inc. and a client of the latter firm).

2. In his seminal work, H. Manne, Insider Trading and the Stock Market (1966), Henry G. Manne argued that outside investors who buy and hold are less likely to be
coherent theory of significant investor harm has been developed by either the
Securities Exchange Commission (SEC) or the courts. The case law is con-
fused beyond coherent explanation, as the authors of one of the leading trea-
tises on securities regulation have noted. 3

Caustion in this Article is intended to mean that which is required for an
event to occur. Here the event in question is the purchase or sale of securi-
ties by a buyer or seller lacking the information possessed by the insider.
To often the insider trading literature treats the magnitude of the loss as an
event "caused" by insider trading. That treatment confuses events and their
consequences. The loss of an investor is caused by revelation of truthful
information, which he or she lacked at the time of trading, and which causes
the market to revalue the particular issuer's shares. The purpose of this Ar-
ticle is to use modern financial theory to examine what triggers investor ac-
tions to buy or sell securities, and how insider trading can trigger such
actions. This Article concludes that most trading decisions are reached on
bases entirely separate from the presence or absence of insider trading, and
that only a relatively small set of transactions can be said to be "caused" by
insider trading.

Insider trading is defined here as trading on an informational advantage in
public markets where the advantage is derived from firm-specific informa-
tion about the issuer, rather than from information about general market
conditions. Such information may be obtained by virtue of a relationship to
the issuer, to a prospective bidder for the issuer's shares, or to agents of
either. Trading may either occur face-to-face or through an impersonal mar-
ket. Where investors are directly solicited, the insider has in fact induced
the other person to transact with him or her, and causation is relatively
clear. 4 These cases are consistent with common law notions of causation
and with common experience, and cause little difficulty. They are not the
subject of this Article, which will focus on trading in impersonal markets.

Finance literature offers real hope for constructing a theory of causation

3. 2 A. Bromberg & L. Lowenfels, Securities Fraud and Commodities Fraud
§ 4.7(551) (1985).
in insider trading cases in impersonal securities markets. One conclusion of this Article is that demonstration of uncompensated harm in insider trading cases is extremely rare, and is dependent upon proof of particular circumstances not previously addressed by the courts. The remoteness of these circumstances casts considerable doubt upon the wisdom of devoting large portions of scarce enforcement resources to policing insider trading.

In part I, this Article will review the legal concept of transaction causation in insider trading. Courts have long recognized the difficulties with finding causation in transactions in impersonal securities markets and have divided over who has in fact been caused to trade. Some courts have held that all traders on the other side from the insider’s position have been induced to trade. Others maintain that no one who trades in impersonal markets is caused to trade. Neither position is entirely correct.

This Article will then examine various legal arguments that insider trading harms others beyond those trading in markets when insiders trade. The well known arguments about harm to issuers from trading by insiders will be reviewed only briefly. Instead, this Article will focus on the harm to bidders

5. A word of caution is necessary. Modern financial economics is still in its infancy, and even the most widely accepted hypotheses are subject to criticism on the basis that some evidence exists to contradict them. But that fact does not mean that we should reject these hypotheses out of hand; rather, it means that our best understanding of how financial markets operate may be subject to future revision when further evidence requires it.


7. Transaction causation involves the notion that the wrongdoer caused a plaintiff to act in a securities transaction. This is to be distinguished from loss causation, which involves a determination of whether the wrongful act caused harm, even though it did not cause trading by a particular plaintiff, because the plaintiff was relying on the integrity of market processes that were allegedly distorted by the wrongful act. See generally A. Bromberg & L. Lowenfels, supra note 3, § 4.7(551), at 85; Note, Causation and Liability in Private Actions for Proxy Violations, 80 Yale L.J. 107, 123-24 (1970).

8. This Article will not discuss such threshold questions as what information is worth taking seriously, which involves questions of materiality, or whether a particular investor in fact took it seriously, which involves questions of reliance. It is worth noting that the courts generally have rejected reliance as an element of a plaintiff’s case since Affiliated Ute Citizens, especially in class actions involving impersonal securities markets. While the courts have granted plaintiffs a presumption in favor of reliance in omissions cases, defendants are permitted to rebut the presumption. Riffkin v. Crow, 574 F.2d 256 (5th Cir. 1978); Rochez Bros. v. Rhoades, 491 F.2d 402 (3d Cir. 1974), cert. denied, 425 U.S. 993 (1976). See generally T. Hazen, The Law of Securities Regulation, § 13.5, at 463-64 (1985).
caused by trading on advance news of takeovers, and on the harm to financial markets generally that results from investor demoralization due to insider trading. This Article will conclude that all pretense of protecting investors from trading errors, or of protecting issuers or bidders from harm caused by theft of information, has been abandoned by the SEC, which has relied on previously discredited "unfair profits" arguments to justify banning such trading.9

In part II, this Article will examine theories and evidence concerning the nature of investors' decisions to buy or sell particular securities. It will begin with a general review of the current understanding of stock market efficiency, and then proceed to describe the mechanisms of market efficiency that inform traders of valuable information about stocks. Finally, a brief description of the Capital Assets Pricing Model will be presented. The most important observation is that all stocks with the same degree of market risk will carry identical expected returns so that traders will not be moved by a "shortage" or "surplus" of supply or demand to buy or sell particular securities. The financial literature will then be used to develop a description of causation.

In part II, this Article will also examine the implications of this theory for insider trading. Absent some signal to the market by the insider, insider trading induces no traders to enter the market, or to make a decision to buy or sell. Traders on opposite sides of these transactions have reacted to other stimuli in reaching their decisions. To the extent that the market is signalled, and traders decide that some information has not yet been revealed, they generally enter on the same side of the market as the insider, and are thus on notice that some unrevealed information exists.

Generally, only market-makers or specialists may be caused to trade on the opposite side of the market by such insider trading if no one else is available to match an offer. Because of their intimate knowledge of trading patterns in such stocks, these professionals are in the best position to adjust their bid and asked prices to reflect increased buying or selling pressure associated with insider trading. These costs become a general cost of trading for all who trade in such securities and, thus, part of the transaction costs of informing the market about the current value of securities.

Finally, in part III, this Article will make some general observations about

the demand for insider trading rules in view of the fact that little uncompensated harm can be found.

I. INSIDER TRADING IN EFFICIENT MARKETS

This section examines notions of causation in insider trading found in three sources: common law, case law under federal insider trading rules, and recently articulated regulatory justifications for insider trading bans.

A. A Brief History of Causation

Common law doctrines provided little protection for investors who traded under conditions of asymmetric information. Chief Justice Marshall stated the rule early in the 19th century: parties to transactions have no affirmative duty of disclosure. Each party was left to invest whatever he or she felt appropriate in seeking information, or to inquire of the other party to obtain whatever information thought necessary to an informed choice. If the other party chose not to reply, no duty was breached. This rule was applied to securities in Britain in *Percival v. Wright*, even when corporate directors were dealing with their own shareholders. In a triumph of form over substance, courts consistently held that directors only owed duties to the corporation, and not to its shareholders. With two exceptions, this was the dominant rule. The effect of the rule was that buyers and sellers were

---

10. See generally Freeman v. Decio, 584 F.2d 186, 191-95 (7th Cir. 1978); H. MANNE, supra note 2, at 17-26; Conant, Duties of Disclosure of Corporate Insiders Who Purchase Shares, 46 CORNELL L.Q. 53, 54-58 (1960).

11. Laidlaw v. Organ, 15 U.S. (2 Wheat.) 178, 195 (1817) (contract for sale of tobacco, where buyer knew of peace treaty between the United States and Britain. Chief Justice Marshall stated that "[i]t would be difficult to circumscribe the contrary doctrine within proper limits, where the means of intelligence are equally accessible to both parties."). *Contra* Bowman v. Bates, 5 Ky. (2 Bibb) 47 (1810); Frazer v. Gervais, 1 Miss. (1 Walker) 72 (1818) (plaintiff failing to inform defendant of peace treaty between the United States and Britain has duty to disclose, or the transaction is void).

12. 2 Ch. 421, 426 (1902).

13. The courts consistently held that the trust placed in directors only applied to the management of the general affairs of the corporation, including its property. Since directors did not control the sale of another shareholder's stock, they could not be held liable as trustees for the sale of the corporation's stock. A. BERLE & G. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 224 (1932); see, e.g., Lank v. Steiner, 43 Del. Ch. 262, 224 A.2d 242 (1966); Board of Comm'rs v. Reynolds, 44 Ind. 509 (1873); Seitz v. Frey, 152 Minn. 170, 188 N.W. 266 (1922); Connolly v. Shannon, 105 N.J. Eq. 155, 147 A. 234 (1929), aff'd without op., 107 N.J. Eq. 180, 151 A. 905 (1930); Crowell v. Jackson, 53 N.J.L. 656, 23 A. 426 (1891); Carpenter v. Danforth, 52 Barb. 581 (N.Y. 1868). *Contra* Dawson v. National Life Ins. Co., 176 Iowa 362, 157 N.W. 929 (1916); Jacobsen v. Yaschik, 249 S.C. 577, 155 S.E.2d 601 (1967).

caused harm not by the insider’s superior information, but by their own failure to invest in additional information.

The general rule in market transactions was equally clear: there was no affirmative duty to disclose inside information in impersonal dealings on exchanges. An early Massachusetts case held that an insider’s trading caused no harm to any investor because he had not personally solicited any sales by other shareholders. Implicitly, the court held that no causation could be shown since there was no reason to believe the insider’s buy order caused any other shareholders to enter the market. Up until the adoption of the federal securities laws, courts rarely found that nondisclosure was the cause of any harm in securities dealings.

B. Does Insider Trading Cause Harm to Other Investors?

Where an insider in possession of nonpublic information quietly enters an order with a broker who executes it without identifying his principal, has the insider’s trading caused anyone to trade and to suffer harm? If so, who is harmed? These are the questions that have bedevilled the courts and commentators for several decades. They raise, without acknowledging it, the questions first raised by Henry Manne. Conflicting answers can be found in the cases. One line of cases finds that investors make decisions to buy or to sell uninfluenced by the presence of insiders, while another holds that “but for” the breach of the insider’s duty to disclose when trading, uninformed traders would not have bought or sold at the prevailing price. To further compound the difficulties, decisions within the Second Circuit appear to be in conflict, although that court appears not to have acknowledged this state of affairs. Perhaps because these decisions do not articulate their argu-

498, 77 P. 277 (1904); see also Blazer v. Black, 196 F.2d 139 (10th Cir. 1952) (applying Kansas law); Sampson v. Hunt, 222 Kan. 268, 564 P.2d 489 (1977). For an argument that the rule permitting insider trading is no longer the dominant rule, see Wimberly, Corporate Recovery of Insider Trading Profits at Common Law, 8 CORP. L. REV. 197 (1985).

15. Jennings, Insider Trading in Corporate Securities: A Survey of Hazards and Disclosure Obligations Under Rule 10b-5, 10 CORP. PRAC. COMMEN. 111, 114 (1969) (“no common law case ever held that a duty to disclose inside information existed when the transaction was effected on a stock exchange”); 3 A. BROMBERG & L. LOWENFELS, supra note 3, § 7.4, at 11.


17. The rare case was Strong v. Repide, 213 U.S. 419 (1909), where the insider employed an agent for an undisclosed principal to solicit shareholders’ sales. Id. at 421.

18. One court has characterized causation as “a metaphysical concept and its meaning may differ in different contexts and the linkage between causation and result necessary to satisfy the legal concept is not always susceptible of direct proof or mathematical determination.” Gerstle v. Gamble-Skogmo, Inc., 298 F. Supp. 66, 98 (E.D.N.Y. 1969), aff’d, 478 F.2d 1281 (2d Cir. 1973).

19. H. MANNE, supra note 2, at 107-09.
ments about causation very clearly, the Supreme Court thus far has not chosen to resolve the conflict.

1. Trading Without Disclosure Causes Harm to All Traders on the Other Side—Shapiro v. Merrill Lynch

List v. Fashion Park was one of the first insider trading cases to raise the question of causation in impersonal markets. The Second Circuit looked to the common law fraud cases for guidance, but cited a face-to-face case involving nondisclosure. Following the common law precedents, the court held that causation was required to establish plaintiff’s case. The court stated that “[t]he reason for this requirement . . . is to certify that the conduct of the defendant actually caused the plaintiff’s injury.” The court declined to read “out of the rule so basic an element of tort law as the principle of causation in fact.”

The court held that the key elements necessary to prove causation were the materiality of the information and plaintiff’s reliance upon it. While these were necessary elements of causation, they were not sufficient. In dicta, the court defined reliance: “The proper test is whether the plaintiff would have been influenced to act differently than he did act if the defendant had disclosed to him the undisclosed fact.” While this “but for” notion of causation was workable in a face-to-face solicitation, it ignored the crucial

20. 340 F.2d 457, 462-63 (2d Cir.), cert. denied, 382 U.S. 811, reh’g denied, 382 U.S. 933 (1965). I exclude Speed v. Transamerica Corp., 99 F. Supp. 808 (D. Del. 1951), aff’d, 235 F.2d 369 (3d Cir. 1956), which involved nondisclosure in connection with a redemption of a class of securities by the issuer. In Speed, the buyer was fully revealed, and could be presumed (correctly) to have superior information. The causation issue was also raised in Joseph v. Farnsworth Radio & Television Corp., 99 F. Supp. 701 (S.D.N.Y. 1951), aff’d, 198 F.2d 883 (2d Cir. 1952), where District Judge Sugarman, conceding insider’s sales without disclosure of bad news, noted the plaintiff’s purchases of stock occurred after all insider sales were completed, and stated that “[a] semblance of privity between the vendor and purchaser of the security in connection with which the improper act, practice or course of business was invoked seems to be requisite and it is entirely lacking here.” 99 F. Supp. at 706. The court of appeals affirmed per curiam on the authority of Birnbaum v. Newport Steel Corp., 193 F.2d 461 (2d Cir.), cert. denied, 343 U.S. 956 (1952), which implicitly agreed that one not in privity (and thus not an affected buyer or seller) lacks standing to sue.

21. List, 340 F.2d at 461 (citing Strong v. Repide, 213 U.S. 419 (1909)). In Strong, the defendant did not directly solicit plaintiff’s sales, but used an agent for an undisclosed principal to make the purchases.

22. Id. at 462-63.

23. Id. at 462.

24. Id. at 463. This requirement of causation in fact was repeated in Affiliated Ute Citizens v. United States, 406 U.S. 128, 154 (1972).

25. List, 340 F.2d at 462-63.

26. Id. at 463.
element of what induced the plaintiff to enter into a transaction in the first place.

The dicta of List was destined to become the dominant mode of reasoning in some courts. When Douglas Aircraft executives learned that earnings would be well below previous public projections, they informed their underwriter, Merrill Lynch, even before they had firm information on the size of the shortfall. Merrill Lynch tipped its best customers, who sold on the news. The Second Circuit held that where one in a position to obtain nonpublic information from an issuer had possession of such information, it had a duty, in the words of its Texas Gulf opinion, to disclose or abstain.27 But violation of that duty did not answer the question of who was harmed by it.

The court cited dicta from List that "the proper test to determine whether causation in fact has been established in a nondisclosure case is 'whether the plaintiff would have been influenced to act differently than he did act if the defendant had disclosed to him the undisclosed fact.'"28 Further, "the Rule 10b-5 causation in fact requirement is satisfied by plaintiffs' allegation that they would not have purchased Douglas stock if they had known of the information withheld by defendants."29 This approach assumed that "but for" the lack of an announcement by the insiders, there would have been no trading whatsoever in Douglas shares during the relevant period. While the ignorance of outside investors is a necessary condition of uninformed trading on the opposite side from insiders, it is not a sufficient one. Insiders must make a determination to trade, and the court's conclusion means that the insider sales caused all buyers to decide to enter the market.

The courts that have followed the Shapiro approach have generally adopted Shapiro's "but for" method of dealing with causation. While conceding that the insider's actions did not cause the plaintiff, or the plaintiff's class, to trade on the other side, these courts generally argue that "but for" the defendant's violation, plaintiffs would not have been harmed.30 Thus, if

27. Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, 495 F.2d 228, 236-37 (2d Cir. 1974).
28. Id. at 239 (citing List, 340 F.2d at 463).
29. Id. at 240.
30. See, e.g., Elkind v. Liggett & Myers, Inc., 635 F.2d 156, 168 n.23 (2d Cir. 1980) (holding that in open market transactions, the duty to disclose runs to those who traded during the same period that defendant traded, and sustained "substantial losses" during the period of insider trading); O'Connor & Assocs. v. Dean Witter Reynolds, Inc., 559 F. Supp. 800, 804 (S.D.N.Y. 1983); Hickman v. Groesbeck, 389 F. Supp. 769 (D. Utah 1974); Lewis v. Bogin, 337 F. Supp. 311, 227 (S.D.N.Y. 1972). See generally 5A A. JACOBS, LITIGATION AND PRACTICE UNDER RULE 10b-5, § 64.02, at 331-49 (1985). "Some [courts] lost sight of the fact that causation relates to plaintiff's loss and not [to] [sic] his purchase or sale. Consequently, they erroneously found no causation because the plaintiff would have traded anyway." Id. at 341. A more sophisticated elaboration of the "but for" justification involves the empirically unsup-
the defendant trades, "but for" his nondisclosure, plaintiffs would not have traded at market prices unaffected by the inside information.

2. Trading Without Disclosure Causes No Harm to Those Acting on Other Stimuli

The holding of List almost overcame the logical error of its dicta and represents the second theme in the judicial debate over causation. The case involved a corporate director who bought shares in his company on undisclosed information about the possibility of a favorable merger.\textsuperscript{31} Plaintiff, who sold to him in a brokerage transaction, did not ask his broker if any insiders were bidding for his stock, but made a decision, after consulting with his broker, that his current gain on the shares would be a nice profit to realize. The court of appeals affirmed the trial court's decision for the defendant, noting that the trial court presumably inferred that plaintiff "was so desirous of 'the potential five point profit he would make' and so reliant on knowledge acquired through 'his many dealings in the securities field' that the identity of the buyer would have been of little or no concern to him."\textsuperscript{32} Carried to its logical extreme, the decision could have been read to mean that since all participants in impersonal markets generally are without knowledge of the person on the other side of the transaction, and continue to trade under these conditions, then investors are indifferent to buyer identity, do not rely upon it, and thus are not caused to trade by insiders.

Other courts reached similar results. In Reynolds \textit{v.} Texas Gulf Sulphur,\textsuperscript{33} sellers of TGS stock sued insiders who purchased, during the period, information about the mineral discovery that was being kept confidential in order to obtain all necessary mineral rights. Noting that the company had no duty to disclose to all shareholders while securing the leases, the court held that the individual defendants had no disclosure duty and, thus, that their purchases did not cause any damage to the plaintiffs.\textsuperscript{34} Implicitly, the court held that the mere entry of purchase orders by insiders did not induce any outsider to sell and, thus, no causation could be shown. A similar district court ruling in Colorado appeared at about the same time.\textsuperscript{35}

\begin{flushleft}
\textsuperscript{31} 340 F.2d at 460.
\textsuperscript{32} Id. at 464.
\textsuperscript{34} Id. at 558-59.
\textsuperscript{35} In Financial Indus. Fund, Inc. \textit{v.} McDonnell Douglas Corp., 315 F. Supp. 42 (D. Colo. 1970), rev'd on other grounds, 474 F.2d 514 (10th Cir. 1973), Judge Doyle wrote:
\end{flushleft}
Two years after Shapiro, the same question was raised in the Sixth Circuit in Fridrich v. Bradford.36 There the defendant had bought on inside information, earning a profit of $13,000.37 The trial court, following Shapiro, held that he had breached a duty to the entire market, and set damages at $361,000, representing the “losses” of all traders who had sold during the period from the insider’s purchase until the disclosure. Focusing more on the question of causation than did the Second Circuit in Shapiro, the Sixth Circuit rejected Shapiro’s reasoning.38 The court noted that not even the pleadings in Shapiro claimed that defendants’ insider trading “had any influence upon their own decision to purchase.” 39 Rejecting the causation argument of Shapiro, the court held that “defendants’ acts of trading in no way affected plaintiffs’ decision to sell.” 40 If one in possession of inside information is under no general duty of disclosure, absent trading activity, it is clear that all sellers in the market would have suffered windfall losses and all buyers would have windfall gains, if no insiders trade and no disclosure is made.41

Turning to plaintiff’s second theory, the theory of tipping and insider trading, defendants contend that as a matter of law no claim for relief exists under the facts alleged by plaintiff. It is doubtful that tipping which results in insider trading on a national exchange can support a private action for damages under 10b-5. Where a corporation withholds material information from the public, a certain number of persons trading on the basis of insufficient information will be injured. This injury is not increased if corporate insiders who possess inside information are trading on the exchange at the same time. It is the incomplete information, not insider trading, which is the proximate cause of the damage to other investors.

315 F. Supp. at 44.
37. Id. at 311. Other shares purchased by the defendant for his wife showed an appreciation of approximately $74,000 prior to the merger that was the material event. Id. Other defendants also realized trading profits during the relevant period. Id. Dicta appeared to support a rule limiting recovery to the amount of the insider’s profits. Id. at 322 n.33. This would create a rule conditioning recovery on whether a plaintiff’s trade happened to match the insider’s.
38. Id. at 320.
39. Id. at 317. The Fridrich opinion noted that Judge Tenney’s opinion in Shapiro rejected the defendant’s causation analysis, holding that “it is not the act of trading which causes plaintiffs’ injury, it is the act of trading without disclosing material inside information which causes plaintiff’s injury.” Id. (quoting Shapiro v. Merrill, Lynch, Pierce, Fenner & Smith, Inc., 353 F. Supp. 264, 278 (S.D.N.Y. 1972)) (emphasis omitted).
40. Id. at 318.
41. Addressing the Shapiro argument, the court stated that
The flaw in this logic, we conclude, is that it assumes the very injury which it then declares compensable. It does so by presupposing that the duty to disclose is absolute, and that the plaintiff is injured when the information is denied him. The duty to disclose, however, is not an absolute one, but an alternative one, that of either disclosing or abstaining from trading. We conceive it to be the act of trading which essentially constitutes the violation of Rule 10b-5, for it is this which brings the illicit
Having outlined the disarray of the courts on the question of whether insider trading causes investors harm in impersonal markets, I will now turn to arguments that others are harmed beyond those who happen to be trading in impersonal markets on the other side from insiders. Two groups may be harmed: issuers or prospective bidders for corporate control from whom information is taken. Arguments that they are seriously harmed by insider trading do not withstand scrutiny.

C. Does Insider Trading Cause Harm to Issuers?

Diamond v. Oreamuno is perhaps the most famous example of the argument concerning issuer harm in the reported judicial opinions. Two officers of an issuer, upon learning of an increase in costs due to a supplier's price increases, rapidly sold large amounts of stock without disclosure. In a derivative action seeking to force them to account for their profits, the court cited general agency rules that agents must account to principals for profits derived from the principal's valuable information. While the court could find no damage to the corporation, it speculated that the defendants might have damaged the firm's reputation for integrity. No evidence of actual reputational damage was offered; indeed, the court argued that an allegation of damages "has never been considered to be an essential requirement for a cause of action founded on a breach of fiduciary duty." This argument has been considered and rejected by the two other courts. Berle and Means also took the position that issuers were not harmed by insider trading.

There are, of course, cases where insider trading may harm issuers, as in the case of a business opportunity. But the difficulty with this argument is that issuers are not permitted to trade on inside information in selling or

---

benefit to the insider, and it is this conduct which impairs the integrity of the market and which is the target of the rule. If the insider does not trade, he has an absolute right to keep material information secret. Investors must be prepared to accept the risk of trading in an open market without complete or always accurate information. Defendants' trading did not alter plaintiffs' expectations when they sold their stock, and in no way influenced plaintiffs' trading decision.

*Id.* (citations omitted).

42. 24 N.Y.2d 494, 248 N.E.2d 910, 301 N.Y.S.2d 78 (1969). Diamond was not a rule 10b-5 case, but was brought as a derivative action to compel defendants to account for their gains. *Id.* at 496, 248 N.E.2d at 911, 301 N.Y.S.2d at 79.

43. *Id.* at 497-98, 248 N.E.2d at 911-12, 301 N.Y.S.2d at 80.

44. *Id.* at 499, 248 N.E.2d at 912-13, 301 N.Y.S.2d at 81-82.

45. *Id.* at 498, 248 N.E.2d at 912, 301 N.Y.S.2d at 81.

46. Freeman v. Decio, 584 F.2d 186, 188-96 (7th Cir. 1978); Schein v. Chasen, 313 So.2d 739 (Fla. 1975).


48. Brophy v. Cities Serv. Co., 31 Del. Ch. 241, 70 A.2d 5 (1949). In Brophy, the court did not require actual loss in order to grant corporate recovery. See generally *id.*
purchasing their own shares. Furthermore, allowing traders to recover for any "harm" to the corporate issuer is hardly an efficient method of protecting the property rights of the corporation in its own information.\footnote{Arguments that insider trading harms issuers generally revert to claims that corporate information is the property of the shareholders. This statement, of course, begs the question, and it is not clear that shareholders would not prefer to assign property rights in information to managers in order to reduce other compensation costs. These arguments have been well developed elsewhere, and will not be repeated here.}{9}

Arguments that insider trading harms issuers generally revert to claims that corporate information is the property of the shareholders.\footnote{See Carlton & Fischel, The Regulation of Insider Trading, 35 STAN. L. REV. 857, 889-90 (1983).} This statement, of course, begs the question, and it is not clear that shareholders would not prefer to assign property rights in information to managers in order to reduce other compensation costs.\footnote{See Manne, Insider Trading and the Law Professors, 23 VAND. L. REV. 547, 549 (1970) (citing Jennings, Book Review, 55 CALIF. L. REV. 1229, 1234 (1967)).} These arguments have been well developed elsewhere, and will not be repeated here.\footnote{See authorities cited supra notes 2, 48 & 51.}

D. Does Insider Trading Cause Harm to Bidders for Corporate Control?

Bans on informed trading in the takeover area are a relatively recent development.\footnote{See authorities cited supra notes 2, 48 & 51.} Prior to the adoption of the Williams Act, a bidder could acquire an unlimited amount of stock without any disclosure beyond that required by section 16(a).\footnote{15 U.S.C. § 78p(a) (1982).} Market information concerning the identity of prospective buyers and sellers and the intensity of their demand has never been treated as inside information for purposes of rule 10b-5.\footnote{In General Time Corp. v. Talley Indus., 403 F.2d 159, 164 (2d Cir. 1968), cert. denied, 393 U.S. 1026 (1969), Judge Friendly stated: "We know of no rule of law, applicable at the time, that a purchaser of stock, who was not an 'insider' and had no fiduciary relation to a prospective seller, had any obligation to reveal circumstances that might raise a seller's demands and thus abort the sale."} Thus, anyone learning of the bidder's activities was free to trade on that information, just as specialists are free to trade on information about limit orders contained in their order books.\footnote{See Barry, The Economics of Outside Information and Rule 10b-5, 129 U. PA. L. REV. 1307, 1381-85 (1981); cf. Chiarella v. United States, 445 U.S. 222, 231 n.14 (1980) (rejecting arguments that those with regular access to market information are insiders by virtue of the access alone, without a relationship between parties that creates duties).}
Insider Trading

Bidders apparently found that high volume purchases by a single buyer signalled the market and revealed their intentions, causing stock prices to rise. In order to avoid such signals, bidders began to enter into agreements with certain investors to “warehouse” target securities for later delivery. Typically, a bidder would request a mutual fund or similar institution to acquire stock in a target, with the assurance that the bidder would take and pay for the shares on a “most favored shareholder” basis, thus assuring the institution the highest price paid by the bidder to anyone. Since institutions plausibly could buy large blocks for investment purposes, the signalling effect of such actions was weakened. The utility of these arrangements to bidders was frustrated by the provisions of the Williams Act, which treated any such arrangement as a “group” that had “acquired” the target's shares at the time of the agreement if either bidder or institution then held any target shares.

The logic of Dirks v. SEC and Chiarella v. United States made it apparent that traditional rationales for insider trading rules would not necessarily apply where the information was derived from a bidder and where no formal warehousing arrangement was created. While the courts sustained criminal indictments based on trading under these circumstances, the opinions increasingly concluded that damage suits would be frustrated by the fact that target investors were owed no duties by bidders until schedule 13D filings were required, ten days after the bidder obtained 5% of the target's shares. The harm, if any, was to bidders, and they were not generally complaining. In United States v. Newman, the Second Circuit failed to discuss


59. 463 U.S. 646 (1983). Dirks held that there was no duty to forego trading on material nonpublic information obtained from an issuer's employees where the information was not privileged and (in puzzling dicta) where the tippers were not motivated by monetary gain. Id. at 662-67.

60. 445 U.S. at 222. Chiarella held that no 10b-5 violation occurs in the absence of a breach of a duty that arises from a specific relationship and that there is no general duty “between all participants in market transactions to forego actions based on material, nonpublic information.” Id. at 233.

61. 664 F.2d 12 (2d Cir. 1981). “In a tender-offer situation, the effect of increased activity in purchases of the target company's shares is, similarly, to drive up the price of the target company's shares; but this effect is damaging to the offering company because the tender offer
harm to investors at all, and offered only a weak and superficial explanation of how insider trading might harm bidders by driving the target's stock price up. It was only a short step to the ultimate holding that target shareholders were not the protected class where insiders breached a duty of confidentiality owed to a bidder. Thus, target shareholders could not sue for damages based on violations of rule 10b-5.62

In 1980, following Chiarella, the SEC adopted rule 14e-3, which bans trading on undisclosed material information about impending bids where the information is obtained from the bidder, target, or agents of either bidder or target.63 The rule prohibits bidders themselves from tipping others about their intent to make a bid, thus closing the door on informal warehousing.64 At the same time, the Commission made it clear that it was not relying on the "theft of information" rationale to justify this ban.65 The rationale given by the Commission was not based on the resulting harm to either bidders or traders, but rather on the old (and since rejected) "unfairness of informational asymmetries" argument.66

II. THE ECONOMICS OF CAUSATION

Having described the logical morass of legal theories about how insider trading causes harm, this Article now focuses on financial economics for will appear commensurately less attractive and the activity may cause it to abort." Id. at 17-18 (citation omitted).


63. 17 C.F.R. 240.14e-3 (1986) (effective October 12, 1980); see Exchange Act Release No. 17,120, [1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,646 (Sept. 4, 1980). While the sequence of the text suggests adoption in response to the Morgan Stanley opinion, it was clear that the Commission saw the handwriting on the wall after Chiarella, and began a rulemaking proceeding to fill the regulatory gap that it anticipated.


theories and evidence about investor behavior. "Causation" is, of course, a legal and not an economic concept. But economists' descriptions of investor choices and behavior can illuminate the legal issue. Absent possession of information they believe is not shared with other traders, rational investors are indifferent as between a great many stocks carrying the same risk and expected returns. Because of the presence of a large number of financial instruments that are perfect substitutes, elasticities of demand and supply are extremely high over very large ranges. This elasticity generally will not cause investors to be influenced by trading volume, whether by insiders or by others, in any particular security. Only specialists and market-makers will be caused to buy or sell by insider activity in most cases. Where insider trading is detected, it reveals valuable information to other traders, who will enter on the same side of the market as the insiders and thus can claim no harm. Further, most insider trading will cause no compensable harm either to issuers or bidders for corporate control.

A. Efficient Capital Market Theory

Theories and evidence about investor choices and behavior center on how participants in capital markets process new information. It would be redundant to repeat all of the evidence in support of what Michael Jensen has called one of the best established propositions in all of the social sciences: the Efficient Capital Markets Hypothesis. Beginning with research that established that stock price movements are unpredictable, researchers were able to infer that stock markets were efficient in a weak form—that nothing in the sequence of past stock prices enabled us to predict future price movements. From that, researchers proceeded to test stronger claims of market

67. Production theory has been the source of economic descriptions of actions between tortfeasors and victims generally. Thus, when the acts of two or more actors are necessary, as in the production of a tort, economists characterize this as a joint output, without allocating causal responsibility to either party. See generally Haddock & Curran, An Economic Theory of Comparative Negligence, 14 J. LEG. STUD. 49 (1985).


efficiency. The semi-strong form asserted that all publicly available information about issuers was reflected in stock prices, while the strong form asserted that all such information, public or not, was reflected.\footnote{J. LORIE \& M. HAMILTON, supra note 69, at 71.}


There is, nevertheless, some contradictory evidence.\footnote{Several studies show that some traders may earn systematically abnormal returns by following investment advisers' recommendations. Bjerring, Lakonishok \& Vermaelen, Stock Prices and Financial Analysts' Recommendations, 38 J. FIN. 187 (1983); Black, Yes, Virginia, There is Hope: Tests of the Value Line Ranking System, 29 FIN. ANALYSTS J. 10 (Sept.-Oct. 1973). Other research has found that stocks with lower price-earnings (P-E) ratios tend to outperform stocks with higher P-E ratios, after adjusting for risk. Basu, Investment Performance of Common Stocks in Relation to Their Price-Earnings Ratios: A Test of the Efficient Market Hypothesis, 32 J. FIN. 663 (1977). Other studies have found that higher risk stocks are overpriced because they generate lower returns per unit of risk. R. BREALEY, AN INTRODUCTION TO RISK AND RETURN FROM COMMON STOCKS 42-54 (1969). Some evidence suggests that the market does not respond with complete efficiency to some forms of public information. Givoly \& Lakonishok, The Information Content of Financial Analysts' Forecasts of Earnings: Some Evidence on Semi-Strong Inefficiency, 1 J. ACCTG. \& ECON. 165 (1979).}

Thus far, evidence does not support an alternative theory. Those who make general challenges to the semi-strong form may make anecdotal arguments, or argue that market participants sometimes play sub-games so that some stock prices inaccurately reflect "intrinsic values,"\footnote{See, e.g., Lowenstein, supra note 71, at 274.} or that bargains can be found and Roberts, others devised tests of this randomness, using more extensive bodies of data. Moore, Some Characteristics of Changes in Common Stock Prices, in THE RANDOM CHARACTER OF STOCK MARKET PRICES 139 (P. Cootner ed. 1964); Fama, The Behavior of Stock Market Prices, 38 J. BUS. 34 (1965); Granger \& Morgenstern, Spectral Analysis of New York Stock Market Prices, 16 KYKLOS 1 (Spring 1963). For a more rigorous formal proof of the independence of successive stock prices changes, see Samuelson, Proof that Properly Anticipated Prices Fluctuate Randomly, 6 IND'L MGMT. REV. 41 (1965). A simplified and nonmathematical summary of Samuelson's proof appears in B. LEV, FINANCIAL STATEMENT ANALYSIS: A NEW APPROACH 217 (1974); cf Mandelbrot, Forecasts of Future Prices, Unbiased Markets, and "Martingale" Models, 39 J. BUS. 242 (1966); SAMUELSON, Proof that Properly Discounted Present Values of Assets Vibrate Randomly, 4 BELL J. ECON. \& MGMT. SCI., 369 (1973). For a summary of attempts to reject the weak form of the efficient capital markets hypothesis, see J. LORIE \& M. HAMILTON, supra at 70-83.}

\footnote{\textit{Id.} at 286 (citing B. MALKIEL, A RANDOM WALK DOWN WALL STREET 79-80 (2d College ed. 1981)).}
in supposedly efficient markets.\textsuperscript{75} The most recent criticism, that of Gordon and Kornhauser, appears merely to be that the tools used to test market efficiency are not necessarily accurate.\textsuperscript{76} But none of these studies challenge the general proposition that markets are effective, if not perfect, processors of information about the value of firms.\textsuperscript{77} Further, little evidence challenges the conclusion that markets are unbiased predictors of future values,\textsuperscript{78} and that is the most important feature of this literature for purposes of this Article.

The strong form of the Efficient Capital Markets Hypothesis argues that stock prices reflect all available information about firms, so that gains are unavailable even to insiders. However, empirical tests have demonstrated that insiders do indeed earn above-normal returns on their trading.\textsuperscript{79} On the other hand, the semi-strong form now appears supported by this evidence,

\textsuperscript{75} Wang, supra note 71, at 377-94 (convertible debt that sells below conversion value and dual purpose closed-end mutual funds that sell below net asset value).

\textsuperscript{76} Gordon & Kornhauser and Wang argue that the Capital Assets Pricing Model (CAPM) is not adequate to test the propositions it examines. Gordon & Kornhauser, supra note 71; Wang, supra note 71, at 366-75. A broader version of the CAPM is set out by Ibboton, Diermeier & Siegel, The Demand for Capital Market Returns: A New Equilibrium Theory, 40 No. 1 FIN. ANALYSTS J. 22 (Jan.-Feb. 1984).

\textsuperscript{77} It is important to focus for a moment on the conditions required for efficient securities markets. Information must be available to a sufficient number of investors so that ample trading can take place on new information to drive prices to the correct level. Transaction costs must be reasonable, in the sense that brokerage fees cannot be so high that they preclude trading on relatively modest bits of information. Finally, there can be no evidence of consistent superiority or inferiority by major market participants, eliminating the possibility that you can fool all of the people all of the time. See generally J. Lorie & M. Hamilton, supra note 69, at 80; Fama, supra note 71. It is generally agreed that these conditions are satisfied for companies listed on the New York Stock Exchange, where trading volume is heavy enough to justify research on all listed companies, and where a number of analysts are likely to follow each firm's stock. J. Lorie & M. Hamilton, supra note 69, at 80, 98-99, 109; H. Kripke, THE SEC AND CORPORATE DISCLOSURE: REGULATION IN SEARCH OF A PURPOSE 85 (1979). But see Barry, The Economics of Outside Information and Rule 10b-5, 129 U. Pa. L. Rev. 1302, 1349 (1981) (arguing that even the NYSE may not be efficient for smaller listed companies not closely followed by major investment media).

\textsuperscript{78} Possible exceptions to this statement include the small firm anomaly, discussed infra note 100, stocks with low price-earnings ratios, stocks with low prices, and stocks selling below liquidation value. Wang, supra note 71, at 353-54. See generally Keim, The CAPM and Equity Return Regularities, 42 FIN. ANALYSTS J. 19 (May-June 1986).

\textsuperscript{79} See, e.g., Baesel & Stein, The Value of Information: Inferences from the Probability of Insider Trading, 14 J. Fin. & QUANTITATIVE ANALYSIS 553, 567-69 (1979) (ordinary insiders earned positive premium relative to uniform traders); accord Finnerty, Insiders and Market Efficiency, 31 J. Fin. 1141, 1142 (1976); Jaffe, The Effect of Regulation Changes on Insider Trading, 5 Bell J. Econ. & MGMT. Sci. 93, 114 (1974); Jaffe, Special Information and Insider Trading, 47 J. Bus. 410 (1974) [hereinafter Jaffe, Special Information]; Keown & Pinkerton, Merger Announcements and Insider Trading Activity: An Empirical Investigation, 36 J. Fin. 855 (1981); Lorie & Niderhoffer, Predictive and Statistical Properties of Insider Trading, 11 J. Law & Econ. 35, 52 (1968); Pratt & DeVere, Relationship Between Insider Trading and Rates
since the most recent study shows that it is unlikely that outsiders can gain from emulating insiders' trades.\textsuperscript{80}

The significance of these findings can be stated simply. Where stock markets are efficient, public announcements will immediately affect the price of a security, without the necessity of any trading, as traders rapidly adjust reservation prices to reflect the new information. Sophisticated traders will realize that there is little reason to trade on the basis of this announcement, to the extent the information contained in these filings is unambiguous in its significance to investors. Ambiguous information that is publicly available may have trading value, but it may require expenditures of considerable resources to enable traders to extract significance (and therefore value) from it.\textsuperscript{81}

Only unsophisticated traders might believe that they can win at this stage by "beating the market." They are naive to hold this belief, and can hardly be described as "prudent" in expending resources to trade on information that has no value. Sophisticated traders, on the other hand, can confidently alter their portfolios knowing that the market reflects all of this information.

\textsuperscript{80} Seyhun, \textit{Insiders' Profits, Costs of Trading, and Market Efficiency}, 16 J. Fin. Econ. 189, 210-11 (1986). Seyhun's study rejects the conclusions of earlier studies, suggesting that a trading rule could be developed that allowed above normal profits on emulating insiders' trades. \textit{Id.} at 210; see, e.g., Jaffe, \textit{Special Information}, supra note 79, at 427 (outsiders can profit by prompt use of insiders intensive trading); Lorie & Niederhoffer, supra note 79, at 52 (proper and prompt alaysis of insider trading can be profitable). Seyhun's study does not reject the evidence that market makers also earn abnormal returns, since they have access to nonpublic information about future transactions, in their limit order books. Another study of insider trading reached opposite conclusions. Givoly & Palmon, \textit{Insider Trading and the Exploitation of Inside Information: Some Empirical Evidence}, 58 J. Bus. 69 (1985). These authors claim that insider gains in the absence of the announcement of significant firm news can be explained on the basis of traders' adjustments in response to the observation of insider trading. The difficulties with this argument involve the anonymity of traders. See Copeland & Galai, \textit{Information Effects on the Bid-Ask Spread}, 38 J. Fin. 1457, 1459 (1983). Further difficulties with the signalling argument are apparent from the fact that insiders' profits do not vary with the size of the trade, although larger trades might be thought to send stronger signals. Givoly & Palmon, supra at 79-80.

\textsuperscript{81} Gilson & Kraakman, \textit{The Mechanisms of Market Efficiency}, 70 Va. L. Rev. 549, 585 (1984), use the example of an innovative securities offering, which investors may not fully understand, or appreciate the value of, at first offering. I have made the same point with respect to takeover defenses; that investors have difficulty assessing the significance (and value) of innovative shark repellent amendments until the market has some experience with their effects on bids. Carney, \textit{Two-Tier Tender Offers and Shark Repellents}, 4, No. 2 Midland Corp. Fin. J. 48 (1986). Recently, an issuer has made similar claims of a lack of market understanding in pricing a new issue on a discounted cash flow basis rather than on a multiple of earnings. \textit{Coke Bottling Firm Chief Defends Price of Offering}, The Atlanta Constitution, Dec. 2, 1986, at B1, col. 2.
Indeed, that has been one of the goals of the securities laws—to build confidence in the securities markets.

B. The Mechanisms of Market Efficiency

The point here is not to test whether or not capital markets are efficient, but to examine the processes by which prices reflect information of various types. This Article will follow the model of Gilson and Kraakman, which attempted to link the three forms of the Efficient Capital Markets Hypothesis with the mechanisms used to distribute information. As these authors pointed out, to say that sooner or later prices will reflect certain information is not by itself very interesting; the most critical question is “How long does it take?”

Weak form market efficiency presumes that information is readily available to all traders. This includes old information, such as price histories, as well as information about current events, such as important news items. Indeed, even news stories about particular firms affect prices too rapidly to support trading profits. In these instances, no particular trading seems required to move stock prices to adjust to new widely distributed information. Thus, public announcements of Federal Reserve Board policy changes can be met with instantaneous changes in the reservation prices of traders, just as major company announcements can. Gilson and Kraakman point out that where news is incomplete, uncertainty about future prospects will remain until events or announcements resolve the uncertainty. During this period, a certain amount of trading activity will occur to fine-tune the price to reflect the consensus of traders’ assessments.

Semi-strong form market efficiency shifts from “publicly distributed” information to “publicly available” information that is not known to all market participants. For example, experts pore over government filings by issuers, such as SEC reports, to analyze this information. The resulting market insights might be available only to such experts. Studies support the assertion that stock markets also reflect this information with such rapidity that no extraordinary trading profits are generally available. Since virtu-
ally all such disclosures are historical rather than forward-looking, they provide only weak insights about the future performance of a firm. Because this information is not readily available to all traders (at least in a useful form), price adjustments to such information rely on trading by a minority of market traders—informed professionals. Gilson and Kraakman explain this in terms of the trading volume controlled by market professionals, but volume arguments, standing alone, raise serious questions about market efficiency. The evidence to date suggests that all stocks with similar beta coefficients are treated as fungible by investors, so demand for any given security is perfectly elastic, absent special information about an issuer. In this context, volume is relevant to price only to the extent that it signals traders that someone is apparently acting on superior information.

Thus far, this Article has described the forms of market efficiency generally accepted by the SEC when designing an integrated disclosure system and rules governing shelf registrations. Here, there seems to be a consen-

Kennelly, The Informational Content of Quarterly Earnings: An Extension and Some Further Evidence, 45 J. Bus. 403, 414 (1972) (same results); Fama, supra note 71, at 387-88; Benston, The Effectiveness and Effects of the SEC's Accounting Disclosure Requirements, in ECONOMIC POLICY AND THE REGULATION OF CORPORATE SECURITIES 23 (H. Manne ed. 1969). Where information is revealed that has ambiguous significance for future periods, price adjustments may be slower. Thus, “surprise” announcements about earnings, and revisions of financial analysts' forecasts may entail adjustments over several months. For a summary of studies demonstrating price adjustments, see generally Wang, supra note 71, at 364 nn.60-61. The statement that superior returns from analysis generally are not available should be taken narrowly, in the sense that “on average” such returns are not available. Some participants may earn superior returns from superior analytical skills, but on average, additional investment in financial analysis will earn only market rates on resources so invested. See J. LORIE & M. HAMILTON, supra note 68, at 100-05; B. LEV, supra note 69, at 121-24.

88. Gilson & Kraakman, supra note 81, at 571 n.69 (citing Dann, Mayers & Rabb, Trading Rules, Large Blocks and the Speed of Price Adjustment, 4 J. Fin. Econ. 3, 18-21 (1977) (a study showing rapid market adjustments to the news of block trades)).

89. As few as 2200 investors or traders are reported to account for 88% of New York Stock Exchange trading activity. A Discussion of Corporate Financial Information 2, No. 1 MIDLAND CORP. FIN. J. 40, 45 (Spring 1984) [hereinafter Stern] (discussion by J. Stern).


91. See, e.g., Financial Industrial Fund, Inc. v. McDonnell Douglas Corp., 474 F.2d 514 (10th Cir.), cert. denied, 414 U.S. 864 (1973), where a mutual fund reached a decision to buy Douglas stock at a time when Douglas' underwriter had tipped some institutions about forthcoming bad news about Douglas' earning. "Plaintiff"'s officer who was instrumental in reaching the decision to buy was surprised at the large number of shares offered [when plaintiff began buying], and he ordered that purchases stop." Id.

Insider Trading

sus among lawyers and economists that markets are fully informed about the data disclosed. Investors can confidently rely on this information when trading in securities in efficient markets, without undertaking further analysis on their own. With respect to this data, at least, stocks are assumed to be fairly priced, in the sense that there is no systematic bias. Insiders who are aware of this information can trade freely on it, confident that the courts will not find any unlawful informational advantage over other market participants.

Moving from information that is publicly available to firm-specific information not formally announced or released, price adjustments become more complex, and less well documented. Market participants act as if markets are not efficient, and as if information can produce gains. This has been described as the paradox of efficient markets; in order for them to function, participants must disbelieve in the hypothesis.\textsuperscript{93} Expenditures on securities research may provide more or less perfect substitutes for much inside information. There are reports that traders and analysts spend as much as $600 million seeking information.\textsuperscript{94} Securities analysts attempt to duplicate inside information by researching sources identical or similar to those providing insiders with their insights. Suppliers, customers, and competitors are all potential sources.\textsuperscript{95}

\textbf{C. The Capital Asset Pricing Model}

The claims made in the empirical literature cited in this Article rely on a model of investor choice that requires some simplified explanation. The Capital Asset Pricing Model (CAPM) is based on modern portfolio theory. Simply stated, modern portfolio theory teaches investors to eliminate all risk related to specific firms through diversification,\textsuperscript{96} and to select the level of

\textsuperscript{93} Grossman & Stiglitz, \textit{On the Impossibility of Informationally Efficient Markets}, 70 \textit{Am. Econ. Rev.} 393, 404 (1980). If there were no gains from investments in information, traders would not invest in research activities, and prices could not remain efficiently set. Similarly, if traders believed that market efficiency precluded profits from seeking information, markets would oscillate between efficiency and inefficiency, since traders would discover disparities between market prices and their own assessments of value, which would provide incentives for research. See Gilson & Kraakman, \textit{supra} note 81, at 577.

\textsuperscript{94} \textit{A Discussion of Corporate Financial Information}, 2, No. 1 \textit{Midland Corp. Fin. J.} 40, 64 (Spring 1984) (discussion by Weare).

\textsuperscript{95} Stern, \textit{supra} note 89, at 55.

\textsuperscript{96} Risk related to the events affecting a specific firm is quantified as the "alpha" factor by financial economists. It is also called "unsystematic" risk. See generally R. Brealey \& S. Myers, \textit{Principles of Corporate Finance}, 170, 172 (2d ed. 1984). For the role of diversification in eliminating this risk, see generally id. at 123-26; Bines, \textit{Modern Portfolio Theory and Investment Management Law: Refinement of Legal Doctrine}, 76 \textit{Colum. L. Rev.} 721, 752 (1976); Modigliani \& Pogue, \textit{An Introduction to Risk and Return}, 30 \textit{Fin. Anal. J.} 68, 76-79.
risk and return by mixing risk-free investments, risky investments, and borrowings in a manner that maximizes personal utility. The CAPM begins with the notion that there is some risk that cannot be diversified away; all stocks, for example, are subject to market risk: factors that affect virtually all stock prices in the same direction, if not in the same magnitude. Risk and return generally are measured against the returns available from holding a portfolio consisting of (or comparable to) the entire market. The risk premium demanded by investors can be observed as the difference between the expected yield on the market portfolio and on a risk-free portfolio of Treasury bonds. Thus, if one's portfolio is less variable than the market, the expected rate of return will be less than the market rate, but always greater than the risk-free rate available on Treasury bonds. Where one's portfolio is more variable than the market, a higher rate return than the market rate will be required. The portion of risk represented by the relationship between the riskiness of the market and the riskiness of a particular security is called the "beta" factor. This model also applies to individual securities. If markets were perfectly efficient, returns on all stocks would lie along a line that positively correlated market risk and return. Assuming portfolio diversification and knowl-
edge that all stocks are priced in efficient markets, and a consequent perfect correlation between expected returns and market risk, investors should be indifferent between holding any two securities with the same beta. Stated differently, all stocks with the same beta are perfect substitutes, absent inside information. This phenomena has been expressed in one text with the aphorism: “Seen one stock, seen them all.” It also means that the demand curve for any given stock is likely to be perfectly elastic over a very wide range.

Myron Scholes offered proof of this proposition in a seminal article testing the price effects of news of secondary offerings. Scholes found that, contrary to conventional (and underwriters') wisdom, a large increase in the supply of a particular security available in the market had no observable effect on price. Price declines were attributable solely to the information effect of secondary offerings, namely, that insiders were selling out. Scholes' proof was based on his observations that price declines were observed in all secondary offerings, but were unrelated to the size of the secondary offering. The major implication of this study for insider trading is that an increase in the volume of buying or selling in any particular security should have no impact on its price, unless traders believe some new information about the issuer exists.
D. The Economics of Insider Trading

What are the implications of this knowledge for the theory that insider trading causes investors harm? The model predicts that investors generally will be indifferent about holding particular stocks, as long as the securities they do hold satisfy their requirements for market risk. Investors can confidently assume that all securities with similar betas carry similar prices for their expected returns. Most investors can also assume that they personally possess no information of any value that they should trade upon. Trading decisions, then, will either be driven by the need to invest additional funds, or by exogenous changes, probably in personal circumstances, that require portfolio adjustments such as liquidations, changes in risk, or expansions of portfolios. Under these circumstances, it is not certain that any outsiders are drawn into the market by insider trading; in anonymous markets, the decisions of outsiders are made independent of insider trading. Only specialists and market-makers committed to taking the other side of unmatched transactions must trade because of insider trading.

Because detection of trading activities by market participants, and the signals they obtain from such detection, are so critical to the impact of insider trading, the following discussion is divided between undetected and detected trading.

1. Undetected Trading

Modern portfolio theory suggests that rational investors believe that they will find no bargains in efficient securities markets, and that an examination of past versus present stock prices and trading patterns will disclose nothing useful. For an investor building an optimal portfolio, the only relevant data is the beta of any given security.

The implication of this theory and the empirical evidence that supports it is that, absent signalling effects, insider trading does not cause investors to engage in transactions in impersonal markets. Since insiders have every reason to conceal the signals of their presence in the markets, generally there is no reason to expect insider trading to cause transactions. Insiders, in part

because of legal prohibitions, trade anonymously.109 Indeed, there is evidence that insider trading generally provides only weak signals to traders.110 And volume by itself is not a reliable indicator of the presence of valuable information. In stocks with considerable liquidity, even institutions are able to buy or sell large blocks without changing the price from the previous trade.111 In perhaps as many as seven hundred firms, liquidity is sufficient to allow institutions to take substantial investment positions or liquidate their holdings without lowering prices.112 Even specialists and market-makers cannot generally discern which trades are based on inside information and respond with price adjustments in particular transactions. Even dealers in over-the-counter stocks cannot readily determine if a stock price change is a consequence of insider trading or not.113 Brokers and others associated with them can occasionally identify those trading on inside information, and emulate them, but the legal prohibitions against insider trading assure that insid-

---

109. A. BERLE & G. MEANS, supra note 13, at 226, 327, note that insiders concealed their trading even before legal prohibitions were in effect. While the authors concluded that such secrecy demonstrated that insiders regarded such trading as unfair and immoral, id. at 226, an alternative explanation might be that insiders wished to avoid signalling the existence of valuable information that could change reservation prices before they executed their trades.

Copeland & Galai, supra note 80, at 1459, assume in their model that a dealer making a market in a security does not know before hand whether the other side of a transaction has inside information. “If markets were personal, then traders known to possess superior knowledge could easily be identified and no one would agree to trade with them. One of the services of a broker is to maintain the anonymity of the client who initiates a trade.” Id.

110. Seyhun, supra note 80, at 207. The author observes that “[i]nsiders would have strong incentive to refrain from trading, or hide their most important information transactions by trading through friends and relatives to avoid potential sanctions by the SEC.” Id. But see Givoly & Palmon, supra note 80 (concluding that insiders make a major part of their stock market gains from information revealed through the trades). Givoly and Palmon offer no explanation of how anonymity is breached, nor why the stronger signals of larger trades do not produce larger abnormal returns. But cf. Plott & Sunder, Efficiency of Experimental Security Markets with Insider Information: An Application of Rational-Expectations Models, 90 J. POL. ECON. 663 (1982) (using a simulation model to demonstrate that markets adjust rapidly to inside information). Plott & Sunder’s results, which suggest extremely rapid price adjustments to new equilibrium levels so that even insiders cannot earn abnormal profits, are inconsistent with the empirical studies cited supra. In their model, uninformed traders can rapidly surmise the value of insider information by observing the competitive bids of insiders. This result may be explained by the fact that the simulation involved use of a situation where either one-third or one-half of all traders possessed the same inside information, and trading was conducted as an oral double auction, similar to an exchange, so that trader anonymity was impossible.


112. A Discussion of Corporate Financial Information, 2, No. 1 MIDLAND CORP. FIN. J. 40, 50-51 (Spring, 1984) (discussion by McConnell).

ers will attempt to disguise their transactions, and thus limit the circumstances in which emulation will be possible.\footnote{114. Gilson & Kraakman, \textit{supra} note 81, at 574 n.81 (citing Cole, \textit{Wachtell Lawyer is Out in Insider-Trading Case}, N.Y. Times, Sept. 12, 1981, at D29, col. 1). The authors reference the case of employees at E.F. Hutton & Co. who detected insider trading by a partner in a major Wall Street law firm in advance of tender offers: "[E]mployees at Hutton are understood to have noticed a pattern in [the partner's] account where, as one source put it, 'He got too lucky . . . .'") \textit{Id.; see also Asquith & Mullins, Signaling with Dividends, Stock Repurchases, and Equity Issues, 15 Fin. Mgmt. 27, 41 n. 18 (Autumn 1986) (noting that block traders routinely mark down the price when buying from sellers whom they fear possess superior information, and raise prices when selling to investors who specialize in speculating on takeover targets).}

Powerful, if anecdotal, evidence of the importance of signalling and the unimportance of trading volume was provided when Edper Enterprises purchased approximately 6.2 million shares of Brascan Limited's stock, or roughly 25% of its outstanding shares, in the course of two days with very little price movement. On April 30, 1979, with bids beginning at $21, Edper was able to purchase three million shares at prices ranging up to $22.75.\footnote{115. \textit{Brascan Ltd. v. Edper Equities Ltd., [1979 Decisions] Fed. Sec. L. Rep. (CCH) ¶ 96,882, at 95,617, 95,624-25 (S.D.N.Y. 1979).} \textit{Id.} at 95,618-19.} Having completed its purchases, Edper then issued a press release stating it had no plans to acquire additional Brascan shares.\footnote{116. \textit{Id.} at 95,625.} The next day, with the market convinced that no further purchases were planned, Edper was able to acquire another 3.2 million shares without increasing its bid price of $22.75.\footnote{117. \textit{Id.} at 95,625.} This evidence of market insensitivity to demands for large volumes is consistent with recent reports of Ivan Boesky's successful attempts to dispose of $1.6 billion of securities in takeover targets without detection.\footnote{118. Recent newspaper reports suggest that arbitrageur Ivan Boesky liquidated holdings in excess of $1.6 billion during the late summer and early fall of 1986 without detection by sophisticated traders, although there were rumors that he was "lightening up" his holdings. \textit{End of Boesky's Firm May Be Near}, N.Y. Times, Dec. 8, 1986, at D1, col. 2.}

The absence of volume effects on stock prices indicates that signals are not generally sent to markets by insider trading. The lack of price changes also indicates that uninformed investors are not induced to enter into market transactions by insider trading. It is only when market orders are insufficient to match the insider's order that additional buyers or sellers must be induced to trade. The trader on the other side of these insider transactions is likely to be the specialist on the exchange or the market-maker in the particular stock, who holds himself ready to trade in the absence of other traders, and who would not trade but for the insider's bid. This is a class of identified traders who are caused to act by insider activity. To the extent that specialists unknowingly deal with insiders, they are unable to adjust reserv-
tion prices to reflect the fact that the insider will probably gain. The general inability of brokers and dealers to detect insider trading as it occurs is evidenced by studies showing that dealers (market-makers and specialists) who must deal against insiders and lose to them, compensate themselves for this risk by increasing the bid-asked spread. These studies find a correlation between the expected volume of insider trading in a security and the size of the spread.

But to say that specialists and market-makers must transact with insiders does not mean that all members of the class have a claim for damages from insider trading. To the extent that the specialist is caused to sell before the announcement of good news, and to buy before the announcement of bad news, causation and injury are clear. But if specialists expect to bear that risk, it becomes an expected cost of doing business, and thus enters into their cost calculations in the same manner as all other costs. Thus, all traders will bear some of the cost of insider trading in a particular stock in the form of transaction costs, and no one trader can claim a disproportionate injury from undetected insider trading. Given high demand elasticities, issuers subject to insider trading will bear part of the costs in the form of higher capital costs. To the extent that insider trading performs services for such issuers, such as compensating managers or assuring accurate security prices, these costs may be trivial or even negative. That is a matter for empirical studies that have not yet been undertaken.

2. Detected Trading

Scholes’ pioneering work first demonstrated the importance of signalling in transactions by insiders. There is no reason to believe that his conclusion should be limited to the context of his study, which involved registered

---

119. Benston & Hagerman, supra note 113; Copeland & Galai, supra note 80; Seyhun, supra note 80.
120. Seyhun, supra note 80.
121. Specialists are generally thought to spend time researching markets, not issuers. Where market-makers face an adverse selection problem when dealing with insiders who possess information not yet reflected in prices:
   The market maker establishes a bid and ask price based on the average information contained in a sale to him or a purchase from him. Those investors with superior information (information traders) can trade at the dealer’s price and make a profit, whereas those without any information (liquidity traders) incur a loss by trading at the dealer’s quotes. Stoll, Alternative Views of Market Making, in Market Making and the Changing Structure of the Securities Industries 67, 78 (Y. Amihud, T. Ho, R. Schwartz eds. 1985).
123. See generally Carlton & Fischel, supra note 49; Haddock & Macey, supra note 51.
124. See generally Scholes, supra note 90.
secondary offerings. Identified trading by insiders does signal the market. It is the identity of the seller that sends a signal, not the size of the trade.\textsuperscript{125}

It is clear that there may be instances where signals are sent. For example, news of mining engineers in hard hats bearing Texas Gulf Sulphur's name rushing to the local brokerage office in Timmins, Ontario, might influence other traders.\textsuperscript{126} Rumors, whether or not based on inside information, may circulate widely enough to change reservation prices for all traders.\textsuperscript{127} A sudden increase in volume, even absent knowledge of the source of trading, can signal traders that material information may exist that has not yet been disclosed. Under these conditions, rational traders may withdraw from the market rather than risk being on the wrong side of trades with insiders.\textsuperscript{128} In these cases, insider trading will deter transactions by those on the other side. If traders can detect on which side of transactions insiders are dealing, they can emulate them, and obtain at least part of the gains anticipated by the insiders.\textsuperscript{129} But they, too, will be dealing with investors whose decisions were made on other bases, or with specialists and market makers. In all of these cases, then, only the latter group can demonstrate transaction causation.

Where price is moved by signals emanating from an insider's trading, such movement may cause prior trading orders to be executed. Thus, where an investor has placed a limit order, to buy or sell a particular security if the market reaches a specified price, that order may be triggered by price movements resulting from observations of insider trading. While plaintiffs might argue that they have thus been "caused" to buy or sell, more analysis is required. To the extent that insider trading reveals the presence of valuable information, it generally moves stock prices in the correct direction.\textsuperscript{130}

\begin{itemize}
\item \textsuperscript{125} Scholes, supra note 90. Givoly & Palmon, supra note 80, confirm Scholes' finding that size of trades does not influence price.
\item \textsuperscript{126} "The rumor mill . . . was going full blast. There were press reports April 9 in the Toronto Daily Star, the Globe & Mail, and in The Northern Miner . . . . The April 9 account in the Globe & Mail [stated that] . . . 'Texas Gulf employees have been heavy buyers of the company's stock through brokerage offices in [Timmins] . . . .'" K. PATRICK, PERPETUAL JEOPARDY 46-47 (1972).
\item \textsuperscript{127} Merrill Action Stumps Street, N.Y. Times, Jan. 24, 1986, at D8, col. 3 (Merrill Lynch's stock subject of heavy trading without apparent explanation); Big Board Analyzes Rumor-Fueled Rise of Merrill Lynch Issue, Wall St. J., Jan. 13, 1986, at 13, col. 3. But see CBS Shares Rise Sharply on Speculation that Investor Group Might Seek Control, Wall St. J., Nov. 4, 1985, at 6, col. 5 (heavy trading clearly linked to rumors); SEC Probing Insider Trading by Market Professionals, Wash. Post, Nov. 5, 1985, at E1, col. 1 (traders purposely start rumors to manipulate market).
\item \textsuperscript{128} See generally supra note 91 and accompanying text.
\item \textsuperscript{129} See authorities cited supra note 80.
\item \textsuperscript{130} Manne first observed this in INSIDER TRADING AND THE STOCK MARKET, supra note 2, at 78-79.
\end{itemize}
such a case, the stock would move to that level at some later date, and the limit order would be triggered in any event. Thus, insider trading has not affected the price at which the outsider buys or sells, but only the timing of the transaction.

Only those traders who can show that exogenous subsequent events caused a countervailing price change in the issuer's stock, so that the limit price would not have been reached upon the later revelations, can demonstrate causation. While there may be other circumstances where some traders can demonstrate transaction causation, these cases are so particularized that their numbers are likely to be trivial. Indeed, the number of limit order trades triggered by detected insider trading is also likely to be trivial.

The result of this analysis is that Fridrich v. Bradford presents a more economically acceptable notion of causation than Shapiro v. Merrill Lynch or its progeny. These latter opinions fail to address the hard questions of causation. If insider traders send no signal when they trade, it is difficult to argue that they have caused any harm, even when measured by captured profits. Even a specialist caused to trade on the other side of the insider's transactions could not prove harm if he was compensated in advance for his losses by his bid-asked spread.

3. Trading on News of Impending Bids

This Article has described the existence of warehousing activities prior to the adoption of the Williams Act. Huge market acquisitions by a single buyer generally signalled the market of an impending bid, and raised reservation prices to reflect that expectation. However, bidders learned that acquisitions by multiple buyers, especially institutions, did not send the same signal to the market. So valuable was this subterfuge that bidders were willing to share the gains from warehousing with the warehousers, by guaranteeing them the difference between the market price and the tender offer price.

The Williams Act effectively precluded warehousing by requiring discl-
sure of the formation of "groups" for the acquisition of target shares. But this did not end the attractiveness of the idea, nor the opportunity to perform a service for a bidder in this fashion. Risk arbitrageurs may be described as the substitutes for warehousers. They purchase shares of targets on the first signal that a company is "in play" (in the expectation of tendering to a bidder). Risk arbitrageurs receive a profit roughly equivalent to that earned by warehousers when a bid succeeds. Their incentive, like that of bidders and warehousers, is to acquire the maximum number of shares possible without signalling the market that a company is in play. There is every reason to believe that bidders find the services of the risk arbitrageurs useful.

The previous analysis concerning undetected and detected trading applies to arbitrageurs' acquisitions. The fact that trading activity in advance of the announcement of a hostile tender offer nearly always increases the target's price suggests that acquisitions are detected by other traders, or that news of impending bids is leaked simultaneously. At the same time, large blocks are accumulated that will be tendered to the bidder. These scenarios are not a perfect substitute for warehousing because bidder and arbitrageurs may


135. See generally Jensen, Don't Freeze the Arbs Out, Wall St. J., Dec. 3, 1986, at 26, col. 4. Indeed, in some cases arbitrageurs can assure the success of a bid by themselves, as in the case of Hanson Trust's bid for SCM. There Hanson terminated its tender offer for SCM shares, and purchased control privately from a few arbitrageurs who held sufficient SCM stock to deliver control. Hanson Trust PLC v. SCM Corp., 774 F.2d 47, 52 (2d Cir. 1985). On the other hand, an arbitrageur who, after acquiring his stock, puts the target "in play" by revealing his ownership, may disserve a particular bidder by encouraging an auction for a target, and by driving the target's stock price to the point where a bidder can no longer offer an attractive premium. This can be viewed as a form of agency cost that cannot be controlled by contract without creating a Williams Act "group" under § 13(d)(3).

136. Many of the event studies of the price of target shares show substantial price advances prior to the announcement of a tender offer. See, e.g., Office of the Chief Economist, Securities and Exchange Commission, Stock Trading Before the Announcement of Tender Offers: Insider Trading or Market Anticipation (1987) (gains of 38.8% prior to the announcement date for successful tender offers); Bradley, Interfirm Tender Offers and the Market for Corporate Control, 53 J. Bus. 345, 363 (1980) (showing gains of approximately 20% for targets later acquired); Dodd, Merger Proposals, Management Discretion and Stockholder Wealth, 8 J. Fin. Econ. 103, 134 (1980) (gains of 29.95%); Dodd & Ruback, Tender Offers and Stockholder Returns, 5 J. Fin. Econ. 351, 363 (1977) (showing gains in excess of 20% prior to the announcement date for targets later acquired). Insiders profit on this information. See Keown & Pinkerton, supra note 79, at 857. But the Office of Chief Economist study, supra, attributes much of the gain to bidder purchases in securing a toehold and to press speculation about impending bids. The study recounts the nature of market-watching by traders designed to detect possible accumulations by bidders.
not contract explicitly without signalling the market of an impending bid. Because of this, arbitrageurs bear more risk than warehousers, since their information about bidder intentions is imperfect. Further, the Williams Act requires that all shares may not be purchased at the bid price if a partial offer is oversubscribed and all who tender are prorated. For the bidder, this means that the volume of shares thus warehoused will be underproduced. Any improvement in the arbitrageur's information will reduce risk and increase arbitrage activity.

This suggests that bidders would prefer leakage of information about intended acquisitions to a select group of arbitrageurs. Investment bankers representing bidders would, under this model, serve their clients by passing on this information to those best able to warehouse large volumes of target securities with the least effect on price. Bidders would not object to such "leakage," and sophisticated bidders would not view it as theft of valuable information, unless the broker or others tipped the target's management or drove the target's stock price to a level that would make the bid more expensive.

This description is consistent with observed behavior. Despite the huge volume of insider trading on tips about bids, and the effect on the price of target shares, bidders usually do not sue their investment bankers or others for theft of this information.

III. WHAT DRIVES THE DEMAND FOR INSIDER TRADING RULES?

So little harm to investors can be demonstrated in most instances of insider trading that it is small wonder courts have avoided extended discussions and analysis of causation issues. The judicial opinions provide no coherent theory of transaction causation that establishes significant harm to investors in impersonal securities markets. Modern descriptions of the oper-

---


138. One news report speculates that Victor Posner may have provided arbitrageur Ivan Boesky with information about Posner's plans to take over Fischbach Corporation, as evidenced by Boesky's sale and Posner's purchase of identical blocks of Fischbach stock and convertible debentures on successive days. Broker's Role: Deals in Boesky Probe Show Increasing Links With Drexel Burnham, Wall St. J., Dec. 5, 1980, at 1, col. 5. Other reports show that insider information acquired by Dennis Levine about impending bids was marketed by his employers to prospective targets, which, while not illegal under the securities laws, represents a harmful use of the bidder's information. Fallen Star: How Inside Knowledge Made, Ruined Career of Dennis B. Levine, supra note 1.

ation of securities markets suggest that uncompensated harm from insider trading may be trivial. Damage suits in insider trading cases, then, would be confined to a very small number by the concepts of trading activity described in Part II of this Article.

Given the trivial amount of harm to individual investors, what theory explains the demand for insider trading rules? The answers to this question are by no means central to this Article, but they are too interesting to ignore entirely. I will explore both public interest and interest group theories below.

A. Public Interest Theory No. 1: Harm to the Market—Insider Trading Sanctions

With the passage of the Insider Trading Sanctions Act, Congress made explicit a justification of insider trading bans not dependent on arguments about harm to specific traders or firms. Congress indicated that the presence of insider trading creates externalities that harm other investors. The most common form of the argument is that knowledge that others are playing with superior information causes demoralized investors to abandon the market, since they will decline to play on terms that dictate systematic losses to insiders. This was in fact the argument used to justify draconian civil penalties for insider trading at three times the insider's profits.

This argument ignores the fact that insider trading generally does not cause any particular investor to trade, and that investors who do trade do so at exactly the price they set as their reservation price. Just as specialists can increase their spreads, other traders can discount the price they pay to reflect expected insider trading losses, although discounts generally should be trivial. Since much insider information need not be disclosed in the absence of trading, the investor is no more harmed by insider trading than by the


142. The House report justified the need for stricter insider trading sanctions on the basis that “[c]apital formation and our nation’s economic growth and stability depend on investor confidence in the fairness and integrity of our capital markets. Insider trading threatens these markets by undermining the public’s expectations of honest and fair securities markets where all participants play by the same rules.” H.R. Rep. No. 355, 98th Cong., 2d Sess. 2 (1983).

143. For a general discussion of investor discounts under such conditions, see Scott, Insider Trading: Rule 10b-5, Disclosure and Corporate Privacy, 9 J. Legal Stud. 801, 807-09 (1980).

144. S.E.C. v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968), cert. denied, 394 U.S. 976 (1969), first enunciated the rule of “disclose or abstain” from trading for insiders. While confusion surrounds the area, see, e.g., In re Carnation Co., Exchange Act Release No. 22,214
lack of disclosure. Indeed, this was recognized in *Fridrich v. Bradford*.¹⁴⁵ Further, to the extent that insider trading is detected, it signals traders of the existence of valuable information, and pushes stock prices toward levels that more accurately reflect the value of the issuer. Traders who are thus reassured that markets are efficient are unlikely to be demoralized by the profits of others.

**B. Public Interest Theory No. 2: Jealousy Will Cause Investors to Forego Superior Investment Opportunities**

Given the obvious weakness of the previous argument, proponents of insider trading bans fall back on a more general, and ultimately unprovable, argument that traders are so jealous and venal that even if insider trading does not cause them harm on particular transactions, they will be demoralized by knowing that others are earning profits they could have earned themselves if only they also possessed the information. Thus, they will forego normal returns because they do not expect to earn extraordinary returns. To state the argument this explicitly is to render it implausible. It also demonstrates the level of abstraction required to make the argument.

But because this argument addresses the entire market, and the willingness of investors to participate in it, it merits further examination, despite this implausibility. Rational investors can choose from a variety of financial instruments, not all traded on securities markets.¹⁴⁶ These investors seek the best available returns given the riskiness of an investment. Stocks compete with all other instruments in this market. To the extent that insider trading reduces expected profits to investors in stocks, it will reduce the price of all stocks subject to insider trading, to the level where stocks once again become attractive and competitive investments.¹⁴⁷ Further, insider trading costs are in fact reflected in bid-asked spreads that compensate specialists for their losses in trading with insiders. These spreads become a cost of raising capital for firms subject to insider trading. In this scenario, if insider trading

---

¹⁴⁵ 542 F.2d 307, 318 (6th Cir. 1976).


¹⁴⁷ This is the same efficiency argument made by Brudney, *supra* note 66, at 356, that insider trading is a public "bad," or a negative externality, that increases the cost of capital generally.
prospects were truly damaging to stock values, we would expect to see firms interested in reducing the cost of capital adopting their own rules against insider trading.\textsuperscript{148} Generally such rules are not observed in U.S. markets, and, indeed, bans on insider trading are by no means universal in other sophisticated securities markets.\textsuperscript{149}

While it is impossible, using current empirical techniques, to test whether investors are in fact driven from the market by the fact that others earn greater profits than they do, recent experience suggests otherwise. Announcements of the SEC's settlement with arbitrageur Ivan Boesky disclosed perhaps the largest identified insider trading profits of all time. Boesky admitted to profits of $50 million, but others have suggested that his profits might have been as large as $200 million.\textsuperscript{150} While the market took a one-day dip, it quickly recovered all of those losses and more, suggesting little investor concern with Boesky's profits. Indeed, the Chairman of the SEC has assured Congress that the Boesky revelations had an insignificant effect on the market.\textsuperscript{151}

The ultimate result must be to question whether the public interest justifies allocation of scarce SEC enforcement resources to this area. In its recent extensions of insider trading bans to the takeover area, the SEC has aban-

\textsuperscript{148} David Haddock and Jonathan Macey have demonstrated that in efficient markets managers will share expected insider trading profits with shareholders by reducing forms of manager compensation. Haddock & Macey, \textit{supra} note 51.

\textsuperscript{149} Even prior to federal regulation,
certain companies, usually under the dominance of some strong individual, decline to permit anyone connected with the concern, whether as director or as employee to conduct speculative operations in the corporate stock. On the other hand, it is certain that this is not the general practice; and that many directors feel perfectly free to buy and sell, though there is a certain squeamishness about disclosing their operations.

\textsuperscript{150} \textit{Boesky Apparently Reaped at Least $203 Million in Illicit Profits With Levine's Inside Information}, Wall St. J., Nov. 24, 1986, at 2, col. 2.

\textsuperscript{151} Testifying at a House oversight hearing on December 11, 1986, SEC Chairman John Shad was reported to have reassured the committee that the repercussion of the announcement proved to be fleeting. "By the end of the (next) week, the market had bounced back, and the market has gone on to a new all-time high." \textit{SEC Permitted Boesky Actions to Cut Partnership's Liabilities $1.32 Billion}, Wall St. J., Dec. 12, 1986, at 3, col. 1.
doned all pretense of investor protection, and has relied on unfairness arguments previously rejected as forming a valid basis for rulemaking under the antifraud provisions of the securities laws. The emphasis, thus, is not on investor injury, but on investor profits and the perception that it is somehow unfair for traders to earn large profits when others do not.

C. Interest Group Theories

The bankruptcy of the SEC’s analysis can only lead to conjecture about hidden agendas. If the public interest does not provide a justification for insider trading bans and enforcement, we must search elsewhere for an explanation for the continued viability of bans on the activity. Are there private interests to be served? Is the SEC protecting the property rights of investment bankers in confidential information received from issuers, the property rights of target managers in their positions, or the interest of the Commission in increasing its enforcement activities?

David Haddock and Jonathan Macey have provided one explanation: they believe that if insider trading is banned, those in the next best position to receive and profit from inside information are investment bankers. Not only is such use of inside information not illegal under insider trading rules, it has been reported in the popular press.

The constant shifting of justifications for insider trading bans in the takeover area suggests that the SEC and managers of target firms may also benefit from these rules, especially as they are applied under the Williams Act. To the extent that arbitrage activity is facilitated by advance information on impending bids, and this activity in turn facilitates transfers of control, incumbent managers of potential targets have strong incentives to advocate retention and extension of the bans imposed by rule 14e-3.

A final potential beneficiary of insider trading bans may be the SEC staff itself. Much SEC activity is of interest to only small groups of voters, and thus to small numbers of the Congress. While the special interests benefitted by these regulations may lobby the Congress to sustain SEC budgets, they may be unable to generate broadly based support for the agency. In con-

152. Haddock & Macey, supra note 51; Macey & Haddock, Regulation on Demand: The Influence of Special Interest Groups on SEC Enforcement of Insider Trading Rules, 30 J. LAW & ECON. (forthcoming, 1987).

153. Dennis Levine’s information was used by his employers to solicit business from prospective targets, which was not forbidden by rule 10b-5, but was harmful to bidders. On the other hand, Levine’s unlawful trades assisted bidders, by accumulating shares that would be tendered. If Levine leaked information to a sufficient number of other traders, causing revisions in reservation prices, this would have harmed bidders. Fallen Star: How Inside Knowledge Made, Ruined Career of Dennis B. Levine, supra note 1.
contrast, insider trading enforcement activity generates headlines. Revelations of large insider trading profits create opportunities for congressional hearings, which in turn provide additional opportunities for SEC requests for budget increases to augment enforcement activity. Recent SEC budget requests suggest that instead of investor protection, the real agenda may be bureaucratic budget maximization, based on a populist campaign against large trading profits.¹⁵⁴

IV. CONCLUSION

Legal theories of investor harm from insider trading are confused at best and overbroad at worst. Investor choices in trading markets are not influenced by the presence or absence of insiders. Only a small percentage of insider trades can be described as causing someone to trade who otherwise would not have done so. The largest percentage of these trades are likely to be with specialists and their spread. The general lack of harm to issuers and bidders for corporate control makes all the more puzzling the demand for insider trading rules, and the moral fervor of the proponents of these rules. The amount of harm suggested by this Article suggests no role for public enforcement of property rights in information in this area beyond that applicable in all other areas.

¹⁵⁴ A recent newspaper article noted that new life has been breathed into antitakeover legislation by reason of these insider trading cases, and that there are renewed calls for a larger SEC enforcement budget and increased enforcement powers for the SEC. Wall Street May Face Big Changes in Wake of the Boesky Scandal, Wall St. J., Dec. 3, 1986, at 1, col. 6. The budget maximization hypothesis was first developed by William Niskanen. See W. NISKANEN, BUREAUCRACY AND REPRESENTATIVE GOVERNMENT (1971).