ON "PROTECTING THE ORDINARY INVESTOR"

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We are presently engaged in yet another round in the almost century-old debate about how the law should protect investors in large publicly-traded corporations.[1] Changes in corporate law recommended by the American Law Institute's Corporate Governance Project purport to remedy perceived deficiencies in existing state corporate codes.[2] One such change would increase the liability of corporate directors and officers for mismanagement.[3] Proposals abound for amending federal securities laws to hamper or facilitate hostile

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1. The classic study of the separation of ownership from control in the corporation is A. BERLE & G. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1933). Another influential contribution is Jensen & Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure,* 3 J. FIN. ECON. 305 (1976). The need for a federal corporation code is a perennial issue in corporate law reform. A leading advocate of such a code was Professor Cary, who characterized Delaware as leading a "race for the bottom" that left shareholders easy prey to self-dealing management. *See* Cary, *Federalism and Corporate Law: Reflections upon Delaware,* 83 YALE L.J. 663, 705 (1974). I first criticized this view in Winter, *State Law, Shareholder Protection, and the Theory of the Corporation,* 6 J. LEGAL STUD. 251 (1977); *see also* Romano, *The State Competition Debate in Corporate Law,* 8 CARDOZO L. REV. 709 (1987); Romano, *Law as a Product: Some Pieces of the Incorporation Puzzle,* 1 J.L. ECON. & ORGANIZATION 225 (1985).

2. PRINCIPLES OF CORPORATE GOVERNANCE AND STRUCTURE: RESTATEMENT AND RECOMMENDATIONS (Tent. Draft No. 1, 1982); PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS (Tent. Drafts Nos. 2 & 3, 1984); PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS (Tent. Draft No. 4, 1985); PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS; *see The ALI's Corporate Governance Proposals: Law and Economics,* 9 DEL. J. CORP. L. 513 (1984); Scott, *Corporation Law and the American Law Institute's Corporate Governance Project,* 35 STAN. L. REV. 927 (1983).

3. *See* PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 4.01 (Tent. Draft No. 4, 1985). Tentative Draft No. 4, § 4.01(a)(1) describes the director's duty of care as a duty "to make, or cause to be made, such inquiry as the director or officer reasonably believes to be appropriate under the circumstances." This language replaced earlier language in Tentative Draft No. 1 that had been strongly criticized by the Business Roundtable and some scholars as a marked change in existing law. *See* J. SELIGMAN, AN ANALYSIS OF THE AMERICAN LAW INSTITUTE'S CORPORATE GOVERNANCE PROJECT 27–32 (1986). Tentative Draft No. 1, § 4.01(b), had required a director "to make reasonable inquiry when acting upon corporate transactions" and "to be reasonably concerned with the existence and effectiveness of monitoring programs, including law compliance programs." PRINCIPLES OF CORPORATE GOVERNANCE AND STRUCTURE: RESTATEMENT AND RECOMMENDATIONS (Tent. Draft No. 1, 1982).

tender offers.[4] Some academics claim insider trading promotes economic efficiency and benefits shareholders.[5] Most commentators disagree, but those who oppose insider trading are widely divided as to why it is undesirable.[6]

Notwithstanding the breadth of disagreement among the contending forces, most participants, now as ever, apparently agree that the debate is over means rather than ends. Most thus agree that the goal is the protection of the investor in common shares of publicly-traded corporations.[7] It is somewhat odd that so much controversy exists in the presence of a shared, or largely shared, goal. One cause of the disagreement, however, is a tendency to ignore the fact that investors are not fungible, that some investors have goals quite different from others, that some investors are less exposed to particular kinds of risks

4. For example, the SEC's Advisory Committee on Tender Offers, which issued its report in July 1983, proposed, among other things, closing the 13(d) window, curbing open market purchases, requiring shareholder approval of greenmail, and the preemption of state laws inhibiting changes in control. SEC ADVISORY COMM. ON TENDER OFFERS, REPORT OF RECOMMENDATIONS TO THE SEC (July 8, 1983). Members of Congress subsequently sought unsuccessfully to pass legislation encompassing many of the Advisory Committee's proposals. *See* Tender Offer Reform Act of 1984, H.R. 5693, 98th Cong., 2d Sess., 130 CONG. REC. H4357 (daily ed. May 22, 1984). Increased calls for changes in the Williams Act followed the Oct. 19, 1987 "crash" in the stock market. *See* S. REP. NO. 265, 100th Cong., 1st Sess. (1987) (report of Committee on Banking, Housing, and Urban Affairs filed Dec. 17, 1987 on disclosure of accumulations of stock and conduct of tender offers).

5. The leading proponent of this view is Dean Henry Manne. *See* H. MANNE, INSIDER TRADING AND THE STOCK MARKET (1966).

6. *See, e.g.*, W. PAINTER, THE FEDERAL SECURITIES CODE AND CORPORATE DISCLOSURE (1979) (fairness requires that shareholders trade on the basis of equal information); Brudney, *Insiders, Outsiders, and Informational Advantages Under the Federal Securities Laws*, 93 HARV. L. REV. 322 (1979) (insider trading raises cost of capital by deterring investment in stock market); Easterbrook, *Insider Trading, Secret Agents, Evidentiary Privileges, and the Production of Information*, 1981 SUP. CT. REV. 309, 332–33 (insider trading may create incentive for managers to increase volatility of a firm's stock price and delay release of financial information to the market); Scott, *Insider Trading: Rule 10b-5, Disclosure and Corporate Privacy*, 9 J. LEGAL STUD. 801 (1980) (laws against insider trading are needed to protect firms' investment in information). These arguments are analyzed in Carlton & Fischel, *The Regulation of Insider Trading*, 35 STAN. L. REV. 857 (1983).

7. *Compare* Lipton, *Takeover Bids in the Target's Boardroom*, 35 BUS. LAW. 101 (1979) (rules permitting defensive tactics enhance shareholder wealth) *with* Easterbrook & Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161, 1164 (1981) (managerial passivity to tender offers increases shareholder welfare) [hereinafter *Proper Role of a Target's Management*]. Lipton also argues, however, that directors responding to tender offers have the right to consider the interests of various noninvestor groups such as employees, customers, suppliers and communities. Lipton, *Takeover Expert Proposes Uniform State Statute*, NEW YORK LAW. J., March 21, 1988, at 21, col. 5. The Delaware Supreme Court has held that, in addition to considering shareholder wealth, directors may consider the impact of a takeover on other "constituencies," such as employees and the community. Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 955 (Del. 1985).

than others, and, most important, that some perform different market functions than others.

In this lecture I propose to differentiate, in a somewhat arbitrary yet analytically helpful way, between four types of investors, and then to consider various issues of corporate and securities law in light of the interests and functions of the different investors. I will style the investors the "Ordinary Investor," the "Speculator," the "Institutional Investor," and the "Entrepreneur in the Market for Management Control." These distinctions are arbitrary because overlap exists between the categories. Moreover, these definitions are not based on how particular investors behave, but on the market functions different kinds of investors perform. Thus, some who consider themselves Ordinary Investors most definitely are Speculators as defined in this lecture.

This approach stems from the assumption that the goal of securities law is to maximize the efficiency of capital markets, and that this goal requires investment decisions to be categorized by the market function such decisions perform rather than by the self-description investors adopt. "Protection" of investors by legal rules is justified where the efficiency of the market functions they perform is enhanced. Where such "protection" avoids losses by certain investors but the losses are no more than the inevitable outcome of competitive markets, such "protection" is likely to reduce rather than to enhance efficiency.

I conclude that the investor least in need of more legal protection is the Ordinary Investor who holds a diversified portfolio and follows a buy-and-hold strategy, and that proposals for further regulation appear principally designed to protect either inefficient speculators or incumbent management.

I. CATEGORIES OF INVESTOR

A. The Ordinary Investor

The "Ordinary Investor," also known as the "average small investor" or the "individual investor," is the "Mom" and "Apple Pie" of the arcane world of corporate law and securities regulation.[8] Few would suggest that protecting the interests of Ordinary Investors is

8. Protecting the ordinary, average, public, or small investor has been a focus of courts. *See, e.g.*, Schlesinger Inv. Partnership v. Fluor Corp., 671 F.2d 739, 743 (2d Cir. 1982) ("Williams Act was meant to protect the ordinary investor"); Feit v. Leasco Data Processing Equip. Corp., 332 F. Supp. 544, 565 (E.D.N.Y. 1971) ("prospectuses [filed under Securities Act of 1933] should be intelligible to the average small investor"). The goal of investor protection has also been shared by Congress, *see, e.g.*, H.R. REP. No. 85, 73d Cong., 1st Sess. (1933) (legislative history of Securities Acts); H.R. REP. No. 1383, 73d Cong., 2d Sess. (1934) (same), and scholars, *see, e.g.*, Brudney & Chirelstein, *Fair Shares in Corporate Mergers and Takeovers*, 88 HARV. L. REV. 297,

second to any other legal goal. Many also believe that Ordinary Investors are the most vulnerable of all investors to fraud, mismanagement, insider trading, and the like.[9]

I describe Ordinary Investors as those who seek profit from investments by capital appreciation of shares, dividends derived from corporate growth, or interest on long-term corporate debt. The market function performed by these investors is to provide capital to equity and long-term debt markets.

Ordinary Investors do not seek to profit from outsmarting the market and buying low and selling high. The costs of acquiring and digesting information to monitor particular companies with a view to frequent trading will exceed the benefits and will put their capital at risk. Therefore, Ordinary Investors follow a buy-and-hold strategy with a diversified portfolio, either of individual stocks and bonds or shares of mutual funds or both.

Diversification greatly reduces the vulnerability of Ordinary Investors to risk. Systematic risk, or risk that applies more or less across the board to particular categories of investment, can be reduced by diversifying among categories—investment, debt, equity, real estate—so as to acquire a portfolio with risks that roughly offset (to the degree possible) each other. Unsystematic risk, namely, risk that is idiosyncratic, or largely so, to particular firms, can be reduced by diversification so that the disasters or great fortune that individual firms encounter are also offset.[10] The ability to hold a portfolio that diversifies against such risks is a critical efficiency because it allows small investors to participate in the capital market with relative safety at low information cost.[11] This diversification, of course, increases the amount of capital Ordinary Investors provide to the market.

Under a buy-and-hold strategy, Ordinary Investors buy and sell only in four circumstances. The first is when their disposable income increases, and they want to increase the size of their portfolios. The second is when they need more disposable income and sell. The third is when they determine that a change in their diversification between categories of investments is desirable. The fourth is when they are

298 (1974) (considering role "substantive requirement of fairness ought to play in providing additional protection to the public shareholders of a merging subsidiary").

9. *See, e.g.,* Bebchuk, *Toward Undistracted Choice and Equal Treatment in Corporate Takeovers,* 98 HARV. L. REV. 1693, 1733–35 (1985) (current takeover rules discriminate against "unsophisticated shareholders"); Brudney, *supra* note 6, at 346.

10. *See* R. BREALEY & S. MYERS, PRINCIPLES OF CORPORATE FINANCE 123–26 (2d ed. 1984).

11. *Id.* at 140–50.

offered a substantial premium for particular shares in a control transaction such as a hostile tender offer. In the case of such a premium, a buy-and-hold strategy may be undesirable either because it prevents a takeover and precludes receipt of the premium, or because the shareholder may later be frozen out at a price less than that of the tender offer.

So far as Ordinary Investors are concerned, the law's goal should be to maximize the value of their investments. This will maintain confidence in the equity market and induce more capital held by Ordinary Investors into that market.

Certainly, many individual investors who consider themselves "ordinary" do not follow a diversified, buy-and-hold strategy. However, for reasons discussed later with regard to legal rules concerning mismanagement, good arguments may be made that the law should not treat them as Ordinary Investors.

B. The Speculator

The second category of investor is the Speculator.[12] Speculators seek financial gain by shifting between categories of investments in anticipation of changes in systematic risk. Within categories of investments they seek gain by outsmarting the market and buying shares at a low price and then selling high, or short-selling high and buying low. They do this by generating, at a cost, information about particular companies and then acting on that information based on their best judgment. In a real sense, Speculators make bets about particular companies and thus about the incidence of unsystematic risk. This is costly in an out-of-pocket sense as well as in the investment of human capital, and Speculators must produce gains exceeding those costs to remain in the market.

The economic function performed by Speculators is to bring efficiency to debt or equity markets by ensuring that the market price of stocks or bonds reflects the intrinsic value of the company based upon the best information and judgment available at any given moment.[13]

12. The most prominent Speculator, until his fall in the recent insider-trading scandal, was Ivan Boesky, who described the arbitrage business in I. BOESKY, MERGER MANIA: ARBITRAGE—WALL STREET'S BEST-KEPT MONEY-MAKING SECRET (1985); *see also* Henry, *Activities of Arbitrageurs in Tender Offers*, 119 U. PA. L. REV. 466 (1971); *The Place of Arbitrageurs in Mergers and Acquisitions*, MERGERS & ACQUISITIONS, July–Aug. 1986, at 24; Rubin, *Arbitrage*, 32 BUS. LAW. 1315 (1977).

13. *See* Gilson & Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549 (1984); Grossman & Stiglitz, *Information and Competitive Price Systems*, 66 AM. ECON. REV. 246 (1976).

This is, of course, a critically important function because the more accurately share price corresponds to intrinsic value, the less risk there will be for the Ordinary Investor. Moreover, although Speculators are largely indifferent to whether particular corporations prosper or perish so long as they predict their fortunes accurately, their actions tend to move corporate assets to their most highly valued use and to reduce unsystematic risk. Where Speculators correctly perceive a corporation as structured or managed in a poor fashion, they will sell or avoid its stock or bonds until their price reflects the greater risk, thereby enhancing the chances of a wealth-increasing takeover. If Speculators correctly anticipate corporate decline, the size of the actual decline may well be reduced by preemptive takeovers. (As discussed below, legal rules encouraging speculation based on prospects of a takeover may be inefficient.) This benefits Ordinary Investors by reducing unsystematic risk. If Speculators are successful in creating an efficient market, therefore, Ordinary Investors will make debt or equity a larger part of their portfolio.

The goal of corporate or securities law with regard to the Speculator should be to allow those who are best at buying low and selling high, or selling high and buying low, to profit and to allow those who do the worst to suffer loses. The law should view Speculators as competitors in a free market and allow those investing in the production of accurate information to keep their profits so that further investment in wealth generating information is made. This is so even if the losing Speculators may be small investors who consider themselves ordinary. Protecting such investors makes the market less efficient and reduces gains to the real Ordinary Investor.

C. *The Institutional Investor*

The third category of investor is the Institutional Investor.[14] Like the Ordinary Investor, this investor seeks gain from capital appreciation and income based on corporate growth, and protects itself from systematic and unsystematic risk through diversification. The Institutional Investor's market function is to provide capital to equity mar-

14. Institutional Investors have become increasingly important in corporate law. In 1933, when the federal securities laws were enacted, institutions owned less than 8.5% of the outstanding stock on the New York Stock Exchange ("NYSE"). By 1970, institutional ownership of corporate stock had reached 17.5%. In 1987, it was estimated that institutions owned more than 30% of all corporate shares and more than 50% of the shares of NYSE companies. J. HEARD & H. SHERMAN, CONFLICTS OF INTEREST IN THE PROXY VOTING SYSTEM 6 (1987). *See generally* Kelly, *The New Dominant Investor,* 9 DIRECTORS & BOARDS, Summer 1985, at 15; Heard, *Institutional Investors Are Flexing Their Muscles,* Legal Times, Oct. 24, 1983, at 11, col. 1.

kets in large blocks. Indeed, some institutions, such as pension or mutual funds, are conduits by which the Ordinary Investor participates in the capital market. However, the Institutional Investor is large enough so that its information cost per share is much less than that of the Ordinary Investor, and it is much more able to accumulate and to act on information relevant to the futures of particular firms. As an investor that seeks to minimize unsystematic risk by generating information about particular companies, the Institutional Investor overlaps with the Speculator. However, unlike the Speculator, the Institutional Investor is not indifferent to whether corporations generally prosper or decline because its primary purpose is to increase its worth through the capital appreciation of, and income derived from, its holdings. The goal of the law with regard to the Institutional Investor is thus largely the same as with regard to the Ordinary Investor.

D. The Entrepreneur in the Market for Management Control

The fourth category of investor is the "Entrepreneur in the Market for Management Control."[15] This investor seeks capital gains by purchasing control of a firm and thereafter increasing its value as a going concern. It may restructure the firm financially, create synergies through consolidation of firms, or install more efficient management. The essential economic function of the Entrepreneur in the Market for Management Control is thus to discipline corporate management so that corporate assets are put to their most valued use. This investor generates information by studying firms and determining which firms can be increased in value by various actions. When the Entrepreneur determines that the current share price is substantially below what it would be if such actions were taken, the Entrepreneur will seek to purchase a control bloc at a price exceeding current price but below a predicted future value. This is a critically important market function. It increases our wealth by increasing efficiency and ultimately benefiting consumers. The law's goal with regard to the Entrepreneur in the

15. Much has been written about the role of the "Entrepreneur in the Market for Management Control" in the capital markets. *See, e.g.*, Coffee, *Regulating the Market for Corporate Control: A Critical Assessment of the Tender Offer's Role in Corporate Governance*, 84 COLUM. L. REV. 1145 (1984); Easterbrook & Fischel, *Auctions and Sunk Costs in Tender Offers*, 35 STAN. L. REV. 1 (1982) [hereinafter *Auctions and Sunk Costs*]; Easterbrook & Fischel, *Takeover Bids, Defensive Tactics and Shareholders' Welfare*, 36 BUS. LAW. 1733 (1981); Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 STAN. L. REV. 819 (1981); Lipton, *Takeover Bids in the Target's Board room*, *supra* note 7; Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110 (1965); *Proper Role of a Target's Management*, *supra* note 7.

Market for Management Control must be to protect its property interest in the information it generates, to maintain fluidity in the Market for Management Control, and to reduce the transaction costs of corporate control transactions.

II. CATEGORIES OF INVESTORS AND RULES OF CORPORATE LAW

I turn now to a discussion of the relationship of each category of investor to pertinent issues of corporate or securities law. I assume that the enforcement of these rules is costless to all investors, a debatable assumption but one necessary to get us home before midnight.

A. Rules Affecting the Power of Shareholders to Direct Corporate Affairs

Many commentators have long decried the seeming impotence of shareholders to direct corporate conduct.[16] Over the years, the issues on which shareholders must vote have diminished. Shareholders are required to approve only fundamental corporate changes, such as mergers or sales of assets, and perhaps charter amendments.[17] Under current state law, cumulative voting is permissive and thus unknown in large corporations.[18] In every state, however, holders of designated classes of stock elect directors with the legal power to conduct the business.[19]

Ordinary Investors are indifferent to whether shareholder power to direct corporate affairs is enhanced or diminished. Diversification's great value is that it enables shareholders to reduce the volatility of their risk without the great costs the generation of information on particular firms entails. The diversified shareholder certainly has no incentive to pay those costs simply to follow the affairs of particular corporations in order to cast an intelligent proxy vote. Moreover, the costs of collective action with other shareholders are so prohibitive

16. *See* A. BERLE & G. MEANS, *supra* note 1, at 4–5, 66–68; Friedman, *SEC Regulation of Corporate Proxies,* 63 HARV. L. REV. 796 (1950); Manning, Book Review, 67 YALE L.J. 1477 (1958). For a dissenting view, see Easterbrook & Fischel, *Voting in Corporate Law,* 26 J.L. & ECON. 395 (1983).

17. *See* DEL. CODE ANN. tit. 8, § 251(c) (1983) (majority approval of shareholders needed for merger or consolidation of domestic corporation); *id.* § 271(a) (majority approval of shareholders needed for sale of substantially all assets); *id.* § 242(b) (majority approval of shareholders needed for charter amendments). Delaware does not, however, require shareholder approval of short-form mergers. *See id.* § 253.

18. W. CARY & M. EISENBERG, CASES AND MATERIALS ON CORPORATIONS 250–61 (5th ed. 1980).

19. *See* W. CARY & M. EISENBERG, *supra* note 18, at 140–42.

that the right to vote is basically irrelevant to the Ordinary Investor. That is the case even with regard to voting for directors because that involves the same costs of information generation and collective action. Of course, the power to vote for directors has a value in the market for management control. Shares with high voting power thus trade at a higher price than shares with low voting power. However, from the perspective of the Ordinary Investor, the market incorporates the value of voting rights in the price at which shares are bought or sold.

Putting aside speculation in the takeover market, which I discuss later, the Speculator's interest in the power to direct corporate affairs is also minimal. Speculators do not generally purchase stock to participate in corporate governance. Rather, they anticipate some favorable or unfavorable change in the corporation's fortunes and, if a shareholders' vote is necessary to that change, approval is usually *pro forma.*

The Institutional Investor has a greater interest than the Ordinary Investor in voting power regarding change in corporate structure or corporate charters.[20] This interest arises from the Institutional Investor's lower information cost per share held in particular corporations than the Ordinary Investor. It also has a lower cost of collective action with other shareholders than the Ordinary Investor because it holds much larger blocks of shares. In contrast to past behavior, some Institutional Investors now openly oppose various management proposals, in particular defensive measures against takeovers embodied in proposed charter amendments.[21] Although to date these efforts appear unsuccessful, the votes seem increasingly close. The Institutional Investor may be directly courted by management, moreover, and this may affect what management puts to a vote. Indeed, the second generation of state antitakeover legislation largely allows management to resort to certain defensive measures without seeking shareholder approval.

Of course, the Entrepreneur in the Market for Management Control has an interest in shares with voting rights so that the Entrepreneur can wage a proxy fight or purchase a control bloc through a hostile

20. On voting by institutional investors, see J. HEARD & H. SHERMAN, *supra* note 14, at 10–23.

21. *See* INVESTOR RESPONSIBILITY RESEARCH CENTER, CORPORATE GOVERNANCE AND SHAREHOLDER RIGHTS 5–14 (1986) (survey indicating increased institutional opposition to antitakeover amendments).

tender offer.[22] Entrepreneurs may also have an interest in providing for shareholder votes that complete a control transaction by, say, a cash-out merger, and make the transaction less susceptible to litigation. They also have an interest in the ability of shareholders to vote on fundamental changes to the extent Institutional Investors are prepared to use that power to oppose defensive measures against takeovers by management.

B. Rules Concerning Fraud and Disclosure

These rules include rules against knowing fraud, such as Section 10(b) of the Securities Exchange Act of 1934,[23] the various federal requirements concerning registration and disclosure with regard to new offerings in the Securities Act of 1933,[24] periodic reporting by large publicly-traded corporations required by the 1934 Act,[25] and disclosure regarding tender offers contained in the Williams Act.[26] My discussion of the Williams Act is subsumed in the later discussion of defensive measures against takeovers.

The Ordinary Investor benefits indirectly from most of these rules.[27] The general rule against knowing fraud guarantees that fraud in the capital market will be deterred, and thus the risk to a particular inves-

22. Successful changes in control of major corporations by proxy fights are relatively rare. A recent example occurred when an insurgent slate was elected to head the board of GAF Corporation. *See* GAF Corp. v. Heyman, 724 F.2d 727 (2d Cir. 1983).

23. 15 U.S.C. § 78j (1982). *See generally* R. JENNINGS & H. MARSH, SECURITIES REGULATION--CASES AND MATERIALS 832–1092 (6th ed. 1987).

24. Section 5 of the 1933 Act prescribes detailed rules for compelling full disclosure to investors of material financial and other information concerning new issues of securities. *See generally* L. LOSS, FUNDAMENTALS OF SECURITIES REGULATION 92–165 (1983). Liability provisions include: Section 11 (liability for misstatements or omissions in registration statement or prospectus); Section 12(1) (liability for offers or sales in violation of Section 5); Section 12(2) (civil liability for fraud or misrepresentation in interstate sale of securities); Section 17 (criminal liability for fraud or misrepresentation in interstate sale of securities). *See generally id.* at 1015–56, 1141–50.

25. Securities Exchange Act of 1934 § 12, 15 U.S.C. § 781 (1982). *See generally* L. LOSS, *supra* note 24, at 459–509.

26. Section 14(d) of the Williams Act requires that, for the protection of shareholders, any party making a tender offer disclose certain specified information to the issuer, the Securities and Exchange Commission, and to any exchange where the security is being traded. 15 U.S.C. § 78m(d)(1) (1982). Section 13(d) requires any party who acquires five percent or more of a registered security to report such acquisition and his intentions regarding the issuer. *Id.* § 78m(g). The antifraud provision contained in section 14(e) makes it unlawful to make any untrue statement of a material fact or "to engage in any fraudulent, deceptive, or manipulative acts or practices" in connection with a tender offer. *Id.* § 78n(e). *See generally* M. LIPTON & E. STEINBERGER, TAKEOVERS AND FREEZEOUTS §§ 2.01–2.13 (5th ed. 1987); L. LOSS, *supra* note 24, at 572–84.

27. The assumption that enforcement of these rules is costless is particularly important here. If, for example, corporations must pay substantial damages to Speculators as a result of section

tor can be greatly reduced through diversification.[28] Fraud is a species of unsystematic risk against which diversification provides protection, much as insurance policies purchased for a premium reduce the cost to a homeowner of common theft. If there were no law against knowing fraud, the risk would be systematic; so too, if there were no law against theft, that risk would not be insurable.

The Ordinary Investor also benefits indirectly from the registration and disclosure requirements.[29] These provide a system of universal, systematic, reliable, and economic (cheap) disclosure. The provisions requiring disclosure of designated information by corporations operates in a way somewhat analogous to a governmental definition of weights and measures.[30] The effect is to provide the market common bases of information about all publicly traded corporations. The existence of a federal registration and disclosure scheme involving pre-approval by a federal agency avoids what might be extremely costly disclosure requirements imposed by the various states and has also reduced litigation over the adequacy of disclosure by particular corporations.[31] Reliability results from the fact that lawyers, accountants, and other parties are at risk as well as the issuer in complying with the registration provisions.[32]

10(b) actions, Ordinary Investors may be the losers. *See* Basic Inc. v. Levinson, 108 S. Ct. 978, 999 (1988) (White, J., concurring in part, dissenting in part).

28. Professors Easterbrook and Fischel argue that a rule against fraud, while not essential in a securities market, is probably less costly than alternative methods of verifying information about firms:

> The penalty for fraud makes it more costly for low-quality firms to mimic high-quality ones by making false disclosures. An antifraud rule imposes low or no costs on honest, high quality firms. Thus it makes it possible for high quality firms to offer warranties at lower cost.The informational warranty, if enforced, makes it unnecessary for buyers to verify information or for sellers to undertake expensive certification. The expenses of offering high quality securities go down while the expenses of passing off low quality securities rise.

Easterbrook & Fischel, *Mandatory Disclosure and the Protection of Investors,* 70 U. VA. L. REV. 669, 677 (1984) (citations omitted) [hereinafter *Mandatory Disclosure*]; *see also* Beaver, *The Nature of Mandated Disclosure,* in SEC ADVISORY COMMITTEE ON CORPORATE DISCLOSURE, REPORT TO THE SEC 618, 637–39 (1977).

29. There has been continuing debate over the merits of mandatory disclosure. *See generally* Coffee, *Market Failure and the Economic Case for a Mandatory Disclosure System,* 70 VA. L. REV. 717 (1984). Professor Stigler first argued that mandatory disclosure was not only costly, but did not significantly improve the quality of information provided to investors. Stigler, *Public Regulation of the Securities Markets,* 37 J. BUS. 117 (1964); *see also* Manne, *Economic Aspects of Required Disclosure under Federal Securities Laws,* WALL STREET IN TRANSITION 23 (1974). For a critique of this view, see Seligman, *The Historical Need for a Mandatory Corporate Disclosure System,* 9 J. CORP. LAW 1 (1983).

30. *See Mandatory Disclosure, supra* note 28, at 700–01.

31. *See id.* at 697–99.

32. *See* Gilson & Kraakman, *supra* note 13, at 613–21; Kraakman, *Corporate Liability Strategies and the Costs of Legal Controls,* 93 YALE L.J. 857 (1984).

To be sure, the registration and disclosure scheme is controversial because we cannot determine whether the benefits of regulation exceed its considerable costs.[33] Moreover, the financial information required to be disclosed is largely historical and may not be the most relevant evidence of corporate prospects.[34] It can be cogently argued, however, that the required disclosure is necessary because of various "free-rider effects" that would cause many firms to refuse to make disclosure absent assurance that others would also do so.[35] Finally, although historical financial information is not the most relevant evidence of corporate prospects, it nonetheless remains important and can be defined in an understandable way that allows economical corporate compliance.[36] Although Ordinary Investors may well never read the prospectuses and periodic disclosure required by the federal securities laws, they will be indirect beneficiaries if the disclosures reduce transactions costs in the equity market.

Speculators and Institutional Investors also benefit from a rule against knowing fraud and from the registration and disclosure required by the 1933 Act. Their benefit from the rule against knowing fraud is somewhat more direct than that of the Ordinary Investor because they are not diversified and thus may be more exposed to the risk of fraud. Moreover, the required disclosure affords them a base of reliable information from which they can generate more information to guide their investment decisions. Greater protection against misstatements or omissions than now exists may be economically undesirable in the case of both Speculators and Institutional Investors, however. One of the market functions of Speculators and Institutional Investors is to make judgments about the prospects of particular corporations, including corporations that may be attempting to mislead investors. Although a rule against fraud is desirable, the law should not create disincentives for Speculators and Institutional Investors to collect information and make judgments regarding the likelihood of fraud.

The Entrepreneur in the Market for Management Control also benefits from the prohibition on knowing fraud because that prohibition enhances its ability to discover overvalued stock. Moreover, the regis-

33. *See Mandatory Disclosure, supra* note 28, at 715 ("We cannot say that the existing securities laws are beneficial, but we are also not confident that their probable replacements would be better.").

34. *See* R. JENNINGS & H. MARSH, *supra* note 23, at 159–71.

35. *See* Coffee, *supra* note 29, at 725–33; *Mandatory Disclosure, supra* note 28, at 680–87, 697.

36. *See Mandatory Disclosure, supra* note 28, at 702–03.

tration provisions of the 1933 Act probably provide information helpful in determining which corporations are likely targets for a takeover.

C. *Rules Concerning Self-Dealing*

The general rule in American corporate law is that corporate transactions benefiting management are not protected by the business judgment rule, but are judged on an arms-length fairness basis.[37] The failure of these rules to prohibit all transactions benefiting management is controversial, but the existing rules have persisted, one suspects, because many such transactions are beneficial to the corporation. Directors may well have lower information costs regarding a particular corporation than outside parties and may be able to identify and execute transactions that, while profitable to them, are nevertheless the best available to the corporation. If the directors could not profit, such transactions might never occur. Directors with widespread contacts in the commercial world are valuable to corporations seeking profitable business opportunities, but such directors cannot be sensibly required to refer every opportunity they come upon to a single corporation rather than claim it for themselves or for another corporation on whose board they serve. Indeed, the benefits to corporations of access to widespread commercial contacts would be severely limited by such a rule. To be sure, there is a risk of self-dealing that may damage the corporation, but such losses must be measured against the cost of prohibiting all such transactions including those that are beneficial.[38] The rule evaluating self-dealing transactions by the standards of arms-length bargaining thus seeks to distinguish between beneficial and harmful transactions.[39]

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37. *See generally* J. BISHOP, THE LAW OF CORPORATE OFFICERS AND DIRECTORS ¶ 3.03-.10 (1981 & Supp. 1987); W. CARY & M. EISENBERG, *supra* note 18, at 563–712.

38. *See* Winter, *supra* note 1, at 277–80.

39. Easterbrook and Fischel characterize judicially enforced fiduciary rules as follows:

> Acting as a standard-form penalty clause in every agency contract, the elastic contours of the fiduciary principle reflect the difficulty that contracting parties have in anticipating when and how their interests may diverge. Socially optimal fiduciary rules approximate the bargain that investors and agents would strike if they were able to dicker at no cost. Such rules preserve the gains resulting from the delegation of authority and the division of labor while limiting the ability of agents to further their own interests at the expense of investors. The existence of such "off-the-rack" rules reduces the costs of transacting and of enforcing restrictions on the agent's powers.

Easterbrook & Fischel, *Corporate Control Transactions,* 91 YALE L.J. 698, 702 (1982); *see also* Wolfson, *A Critique of Corporate Law,* 34 U. MIAMI L. REV. 959, 975 (1980). Other mechanisms for monitoring managers include market controls (i.e., employment, product, capital, and corporate control), *see* Winter, *supra* note 1, 262–66, and organizational controls (e.g., outside directors, accountants, investment bankers), *see* Fama & Jensen, *Separation of Ownership and Control,* 26 J.L. & ECON. 301, 312–15 (1983).

The Ordinary Investor is probably protected by a legal rule of the kind described above because the rule against self-dealing increases value. Like fraud, however, self-dealing is an unsystematic risk against which one can diversify.

Arguably some Speculators might benefit from rules that afford greater protection against self-dealing. Whether the benefits to corporations from such transactions outweigh the losses, even if they greatly outweigh the losses, is irrelevant to Speculators. They are not interested in the growth of corporate value so much as predicting changes in value, up or down, among particular corporations. However, greater protection should not be afforded Speculators because their market function includes making judgments about the quality of management, and those Speculators who are best at detecting honest management should be able to reap a reward as an incentive to make accurate judgments. A rule prohibiting all corporate transactions from which management profited would thus injure Ordinary Investors and prevent efficient Speculators from making gains solely to protect inefficient Speculators from suffering losses.

Institutional Investors are diversified against the risk of self-dealing. Institutional Investors also have a greater interest in benefitting from the appreciation of their value of their holdings than in speculating against particular cases of self-dealing. Present law is thus efficient so far as this investor is concerned.

The Entrepreneur in the Market for Management Control is not affected by such rules except where the self-dealing involves defensive measures against takeovers, which I discuss separately.

D. Rules Concerning Mismanagement

Existing law regarding the liability of directors and officers for mismanagement tends to be stated in the language of ordinary negligence. In practice, until recently at least, mismanagement has rarely resulted in liability except where a director or officer has paid virtually no attention to the affairs of the corporation, has consciously avoided learning about the affairs of the corporation, or has engaged in conduct that puts the corporation in a no-win situation.[40] This limited liability in practice results from the so-called business judgment rule

40. "The search for cases in which directors of industrial corporations have been held liable in derivative suits for negligence uncomplicated by self-dealing is a search for a very small number of needles in a very large haystack." Bishop, *Sitting Ducks and Decoy Ducks: New Trends in the Indemnification of Corporate Directors and Officers*, 77 YALE L.J. 1078, 1099 (1968). Professor Bishop found only four such cases. *Id.* at 1099–1100. The American Law Institute draft report on corporate governance added only two cases to this list. PRINCIPLES OF

that protects directors and officers so long as the business decisions in question were made in good faith and did not involve self-dealing.[41] The rule has not been as protective in practice where directors and officers of banks are concerned,[42] and the recent Delaware decision in the case of *Smith v. Van Gorkom*[43] may signal a generally less protective attitude among the judiciary.[44]

The Ordinary Investor benefits from a business judgment rule protective of management because management is likely to be more risk averse than a diversified investor.[45] The value of an investment is determined by weighing probable returns and the volatility of the risk. Even where there is a seventy-five percent chance of a very high return, a twenty-five percent chance of a substantial loss may cause a risk averse person to select an investment with prospects of very modest gain if the chances of loss are also much less. The diversified investor, however, is assured that the high losses among some companies will be offset by the even greater gains among the rest. That investor therefore prefers the most valuable investment because diversification eliminates the volatility of the risk. Management, however, has a non-diversified investment of human capital in one company and may prefer a less valuable but also less volatile investment.

Consider the following example of a choice between two business decisions having different values and different risks.[46]

CORPORATE GOVERNANCE AND STRUCTURE: ANALYSIS AND RECOMMENDATIONS § 4.01, at 39 n.17 (Tent. Draft No. 4, 1985).

41. *See* Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984) ("under the business judgment rule director liability is predicated upon concepts of *gross* negligence.") (footnote omitted) (emphasis added); Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971) ("A board of directors enjoys a presumption of sound business judgment, and its decisions will not be disturbed if they can be attributed to any rational business purpose. A court under such circumstances will not substitute its own notions of what is or is not sound business judgment.").

42. *See, e.g.*, Francis v. United Jersey Bank, 87 N.J. 15, 432 A.2d 814 (1981).

43. 488 A.2d 858 (Del. 1985).

44. In *Van Gorkom*, the Delaware Supreme Court strictly applied the business judgment rule, stating that the determination of whether a business judgment is an "informed one" in a cash-out merger turned on "whether the directors have informed themselves 'prior to making a business decision, of all material information reasonably available to them.'" *Id.* at 872 (quoting *Aronson*, 473 A.2d at 812). The directors in this case, who relied only on the company's chairman for the valuation of the merger, had not followed the increasingly common practice of obtaining a fairness opinion from an investment bank. *See* Note, *Investment Bankers' Fairness Opinions in Corporate Control Transactions*, 96 YALE L.J. 119 (1986). Commentators have been critical of the *Van Gorkom* decision. *See, e.g.*, Fischel, *The Business Judgment Rule and the* Trans Union *Case*, 40 BUS. LAW. 1437 (1985).

45. *See* Joy v. North, 692 F.2d 880, 885–86 (2d Cir. 1982).

46. This example is adapted from W. KLEIN & J. COFFEE, BUSINESS ORGANIZATION AND FINANCE 208–09 (3d ed. 1988).

Estimated Probability of Outcome	Outcome Profit or Loss	Value
	INVESTMENT A	
.4	+15	6.0
.4	+ 1	.4
.2	-13	−2.6
1.0		3.8
	INVESTMENT B	
.4	+ 8	3.2
.4	+ 1	.4
.2	0	0
1.0		3.6

A is a more valuable investment than B, but the management of a single company is unlikely to choose it over B because twenty percent of the time ruin will result. Management's human capital is not diversified, but is "invested" in that firm. An Ordinary Investor, on the other hand, with a portfolio of many companies that face such a decision, will not fear the twenty percent chance of disaster in choice A because forty percent of the companies choosing A will encounter a bonanza.

Legal rules penalizing managers for taking good faith risks will thus work against the interest of the ordinary shareholder by increasing management's risk averseness. Indeed, this is probably the reason that the business judgment rule has, over the years, been so protective of management. Indeed, after the *Van Gorkom* decision, Delaware amended its code to allow corporations to limit the liability of directors for breaches of the duty of care.[47] The somewhat different rule applied to banks may well be the exception that proves the worthiness of the general rule. Banks are highly leveraged institutions (depositors being debt creditors) and the law is correct in reducing the volatility of the risks they take.

As in the case of rules concerning the duty of loyalty, some Speculators would be helped by a less protective business judgment rule. However, only those Speculators who are the least efficient at distinguishing between good and poor management would be helped. Again, there is no reason to afford poor Speculators special protection from mismanagement. The risk is one they encountered voluntarily and can avoid simply by diversifying and not speculating. Moreover, efficient Speculators who detect weak management may well cause share price to drop in anticipation of mismanagement and cause a pre-

47. *See* DEL. CODE ANN. tit. 8, § 102(b)(7) (1986).

emptive takeover before truly damaging mismanagement actually occurs. Finally, a rule protecting the inefficient Speculator will increase management's risk averseness and thus cause it to choose business strategies that are suboptimal from the Ordinary Investor's point of view.

Institutional Investors probably share the views of Ordinary Investors on this issue. They are protected by diversification in the same way as the Ordinary Investor and gain from legal rules reducing management's risk averseness. They are also in a much better position to protect against mismanagement because of lower information costs per share.

The Entrepreneur in the Market for Management Control has little interest in legal rules concerning mismanagement, because such an investor seeks to profit from mismanagement by purchasing control and providing better management.

E. Rules Concerning Defensive Measures Against Takeovers

Academic, judicial, and political debate continues over the propriety of defensive measures against takeovers. It seems clear that where the purpose of such maneuvers is solely to protect management in their jobs, such measures are illegal.[48] Disagreement persists, however, over whether defensive measures are beneficial to investors because they frequently result in bidding and auctions that increase the share price paid to target shareholders when the takeover is completed.[49]

Whether one can usefully distinguish between defensive measures designed to entrench management and those intended to cause auctions, however, seems doubtful. Management rarely acts without the advice of skilled counsel, and it takes rather little skill to arrange affairs so that the appearance of trying to benefit shareholders is cre-

48. *See, e.g.*, Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 954–55 (Del. 1985) ("Because of the omnipresent specter that a board may be acting in its own interests in a takeover . . . there is an enhanced duty which calls for judicial examination at the threshold before the protections of the business judgment rule may be conferred."); Cheff v. Mathes, 199 A.2d 548, 554 (Del. 1964) ("if the board has acted solely or primarily because of the desire to perpetuate themselves in office, the use of corporate funds for such purposes is improper.")

49. *Compare Proper Role of a Target's Management, supra* note 7 (arguing for rule prohibiting defensive tactics by target management) *and Auctions and Sunk Costs, supra* note 15 (auctions provide small if not negative allocational benefits) *with* Bebchuk, *The Case for Facilitating Competing Tender Offers*, 95 HARV. L. REV. 1028 (1982) (post-bid delays may deter searching, but have countervailing positive effect of promoting beneficial auctions) *and* Gilson, *Seeking Competitive Bids Versus Pure Passivity in Tender Offer Defense*, 35 STAN. L. REV. 51 (1982) (auctions can increase social wealth).

ated. Nevertheless, I will assume for purposes of discussion that such a distinction is viable.

The strongest argument against defensive measures leading to auctions is that raiders have high information costs in identifying companies as appropriate targets. This means less information will be generated and fewer tender offers will be made if the information generated by the first bidder must be shared with a competing bidder who bore no information cost.[50] In a market without the Williams Act or state antitakeover legislation, a raider might make an offer with so short a period for acceptance that competing offers were effectively precluded, the fabled "Saturday Night Special." In a market with such regulation, raiders must signal their intentions well in advance and disclose some of the information they have collected. Competing raiders thus have potential targets costlessly identified, and some explicit information given to them free. They are then able to make a higher offer. Consequently, opponents of auctions argue that fewer tender offers will be made because the costs of generating information must be borne entirely by the first offeror while the rewards of such information are shared with others. Where an auction is likely, therefore, potential raiders will have less profit motive to collect relevant information and to make hostile tender offers.

Conversely, proponents of auctions argue that preventing Saturday Night Specials allows shareholders to benefit from higher bids by competing raiders. They believe that the higher prices paid for shares as a consequence of auctions is larger than the losses suffered from the reduction of the number of tender offers. They also argue that investors can identify potential targets in advance and thereby benefit from ensuing auctions.[51]

The Ordinary Investor appears not to gain from rules that impede the first bidder and lead to auctions. The diversified shareholder has interests in both raiders and targets, and what it may gain through increased bids at auctions for target companies is precisely matched by what it loses as a raider. Moreover, the legal and other costs of auctions must be borne, leading to a net loss for the Ordinary Investor.

Efficient Speculators gain from auctions. If a Speculator identifies the most attractive potential targets under legal rules permitting auctions, then it will profit by investing in companies that are ultimately the subject of *successful* (if the takeover is defeated, share prices may drop substantially) takeovers. It may be, however, that the identifica-

50. *See Auctions and Sunk Costs*, *supra* note 15, at 3–7.

51. *See* Bebchuk, *supra* note 49, at 1035–38.

tion of likely successful takeover targets by Speculators does not contribute to the efficiency of capital markets. As argued above, one function of Speculators is to cause the price of poorly managed companies to fall. If Speculators can anticipate where auctions will occur, they may further reduce the number of desirable takeovers by increasing the price raiders must pay.

The Institutional Investor shares the view of the Ordinary Investor. Given its diversification, auctions impose costs but offer no benefits because the gains to target shareholders from costly auctions are offset by losses to raider shareholders. The Institutional Investor would benefit only if it divested itself of stock in potential raiders and loaded up with stock of potential targets, or in short abandoned diversification and became a Speculator. The growing resistance of certain large pension plans to various defensive tactics, such as poison pills, tends to demonstrate that the Institutional Investor's interest in capital appreciation is paramount.

The Entrepreneur in the Market for Management Control has an interest in avoiding auctions and in protecting property rights in the information it has generated at great cost.[52] It has no interest in seeing Speculators or competing bidders profit from its efforts.

This view prevails, however, only in unregulated conditions. Under present regulations, Section 13(d) of the Williams Act requires that any raider with holdings in a company equalling five percent of shares must announce its presence on the scene.[53] Entrepreneurs may presently have an interest in seeing that Speculators acquire blocs of stock so that the Entrepreneurs can remain under the five percent level and yet have some assurance of later quickly picking up the stock. This of course may create an insider trading problem.

F. Rules Concerning Insider Trading

The rationale for prohibiting gains through insider trading is highly controversial. Traditionalists argue that insider trading is unfair to other traders.[54] More recently, some commentators have proposed

52. *See Auctions and Sunk Costs, supra* note 15, at 3–7.

53. *See generally* L. Loss, *supra* note 24, at 573.

54. *See, e.g.,* Schotland, *Unsafe at Any Price: A Reply to Manne, Insider Trading and the Stock Market,* 53 Va. L. Rev. 1425, 1439 (1967) ("Even if we found that unfettered insider trading would bring an economic gain, we might still forego that gain in order to secure a stock market and intracorporate relationship that satisfy such noneconomic goals as fairness, just rewards and integrity.").

the rationale that insider information is the property of the corporation or its agent and should not be misappropriated.[55]

Certainly the unfairness rationale makes no sense with regard to Ordinary Investors. They buy or sell according to current cash position or need to change the ratio of various categories of investments in their portfolio. It is hard to see how trading by an insider injures such investors. Their decision to buy or sell is based on current cash position or portfolio considerations and not on judgments as to a company's future. The transaction is thus independent of the confidential information. Moreover, Ordinary Investors buy or sell in a diversified manner, and the effect on share prices of insider buying is offset by the effect on share prices of those insiders who are selling. Finally, it should be noted that insider trading makes share prices conform more closely to intrinsic value, a function that largely benefits Ordinary Investors.

The interests of Ordinary Investors are quite different, however, if the vice of insider trading is the misappropriation of corporation property, because such a misappropriation reduces the value of the corporation. Although controversial, the misappropriation theory[56] as a rationale for the prohibition of insider trading deserves consideration. In many of the more celebrated cases, insider trading had the potential or effect of injuring the corporation. In *SEC v. Texas Gulf Sulphur, Co.*,[57] for example, insider trading risked disclosure of the mining strike that might have prevented the corporation from acquiring the necessary mineral rights. In *United States v. Chiarella*,[58] the identification of targets from confidential documents had the effect of making takeovers by the raider, for whom the printer was indirectly working, more expensive. To be sure, one might argue that contract law and

55. *See, e.g.*, Easterbrook, *supra* note 6, at 331; Scott, *supra* note 6, at 814–15.

56. *See, e.g.*, United States v. Newman, 664 F.2d 12, 17 (2d Cir. 1981) (securities trader who fraudulently misappropriated confidential information for personal gain held criminally liable for breaching duty owed to his employer's clients "whose takeover plans were keyed to target company stock prices fixed by market forces, not artificially inflated through purchases by purloiners of confidential information"), *cert. denied*, 464 U.S. 863 (1983). The Supreme Court recently deadlocked 4 to 4 on whether former *Wall Street Journal* editor R. Foster Winans could be convicted of violating Rule 10b-5 by trading on the basis of confidential publication schedules he misappropriated from his employer. Carpenter v. United States, 108 S. Ct. 316 (1987). A bill on insider trading has been introduced in the U.S. Senate that would codify in large part the misappropriation theory. The Insider Trader Proscriptions Act of 1987, S. 1380, 100th Cong., 1st Sess., 133 CONG. REC. S8247 (daily ed. June 17, 1987).

57. 401 F.2d 833, 843 (2d Cir. 1968) (en banc), *cert. denied*, 394 U.S. 976 (1969).

58. 445 U.S. 222 (1980).

the principles of fiduciary obligations afford a civil remedy.[59] However, civil remedies may lead to underenforcement because the costs of private enforcement outweigh the benefits to particular companies. Where the transaction costs prevent the efficient private enforcement of contracts, an appropriate function of government is to reduce those costs.

Some Speculators and Institutional Investors can be harmed by insider trading, but again the inefficient bear the loss. Both are injured only because inside traders are more efficient at performing the market function of Speculators and Institutional Investors, namely moving the price of a company's stock in the most accurate direction. Not all Speculators and Institutional Investors are hurt, moreover. Efficient Speculators and Institutional Investors may notice unexplained trading in a company's shares, accurately identify it as a consequence of insider trading, and then trade themselves. So far as performing the market function of the Speculator or Institutional Investor is concerned, therefore, insider trading is good rather than bad.

So far as Entrepreneurs in the Market for Management Control are concerned, they probably do not like insider trading on the basis of confidential information as to their intentions, at least in unregulated conditions. In such circumstances, Entrepreneurs would have to pay more to effectuate the takeover.[60] In the presence of Section 13(d), however, Entrepreneurs in the Market for Management Control may well desire that Speculators purchase stock in target companies in anticipation of its takeover attempt. This would tend to concentrate shares in large blocs without the Entrepreneur having to comply with Section 13(d).

III. CONCLUSION

In sum, each of the classes of investors I have described performs a market function necessary to the efficiency of equity and capital markets. The goal of the law should be to allow those investors to perform those functions most efficiently even where that permissive attitude will necessarily result in some losses. Losses are an inevitable aspect of competitive markets, and their existence is not evidence of the need for more protective legal rules. That will simply make markets less

59. *See* Note, *Insider Trading by Intermediaries: A Contract Remedy for Acquirers' Increased Costs of Takeovers,* 97 YALE L.J. 115 (1987).

60. *See* Givoly & Palmon, *Insider Trading and the Exploitation of Insider Information: Some Empirical Evidence,* 58 J. BUS. 69 (1985); Keown & Pinkerton, *Merger Announcements and Insider Trading Activity: An Empirical Investigation,* 36 J. FIN. 855 (1981).

efficient and cause other investors to subsidize inefficient members of one class.

Moreover, a credible argument exists that Ordinary Investors and Institutional Investors are much less vulnerable to the risks with which the law has been traditionally concerned than either the Speculator or the Entrepreneur in the Market for Management Control. If so, the view that corporate and securities law needs a wholesale overhaul is meritless. Indeed, many proposals for reform seem designed to reduce the risks for Speculators at a cost to Ordinary and Institutional Investors. Alterations in rules concerning the duty of loyalty and duty of care fall into that category, as do rules that allow defensive tactics against takeovers designed to create auctions. Speculators encounter risks voluntarily, however, and seemingly can avoid those risks by diversifying and following a buy-and-hold strategy. Finally, Speculators are competitors whose function is to make capital markets efficient in pricing. The ensuing competition makes losses an inevitable part of that efficiency.