

# INTERNALIZING OUTSIDER TRADING

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## TABLE OF CONTENTS

I. INTRODUCTION.....	314
II. AN INTERNALIZATION MODEL OF INFORMATIONAL DISPARITY .....	327
A. <i>Disaggregating the Internal and External Impacts of an         Information Advantage</i> .....	328
B. <i>Implications for Insider Trading</i> .....	336
C. <i>Implications for Outsider Trading</i> .....	341
III. THE PRESENT U.S. REGULATION OF OUTSIDER TRADING ...	347
A. <i>Misappropriation Theory</i> .....	348
B. <i>Rule 14e-3 Tender Offer Rule</i> .....	355
C. <i>Regulation FD</i> .....	356
IV. INTERNALIZING OUTSIDER TRADING.....	358
A. <i>The Outsider Trader Dilemma</i> .....	358
1. <i>Third Party Externalities</i> .....	360
2. <i>Managerial Opportunism</i> .....	366
B. <i>Internalization Proposal</i> .....	370
1. <i>Choosing the Right Default</i> .....	377
2. <i>Current Opportunities for Traded Firms to Control             Informed Trading</i> .....	381
3. <i>Tailoring the Opt Out Menu of Trading Restrictions</i> ..	389
4. <i>Summary</i> .....	401
C. <i>Implementation Problems</i> .....	402
V. CONCLUSION.....	404

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## I. INTRODUCTION

Investing in the United States has become a hobby for many.<sup>1</sup> Individual ownership of equity, moreover, has increased over the past decade due in part to the introduction of internet-based trading.<sup>2</sup> While providing the possibility for greater returns compared with bank savings accounts, among other investment alternatives, the public capital markets also pose greater risks for investors.<sup>3</sup> Many individual investors lack both the resources and the incentive to analyze the value of any particular security in the market. Such investors thus trade at a systematic disadvantage relative to more informed parties. In response, regulators have asserted that certain informational disparities cause uninformed investors to lose confidence in the market, thereby justifying stringent regulation.<sup>4</sup> This Article analyzes the impact of information advantages in the market and proposes a unified approach to regulating such advantages.

Informational disparities in the market arise from a number of different sources. An individual investor may contemplate a trade in a particular publicly traded company. Call the company whose securities are being traded the "traded firm". In a world without regulatory prohibitions, individual investors first face the possibility that the traded firm itself will provide nonpublic material information to only a subset of investors in the market. Insiders at the traded firm, for example, may enjoy preferential access to confidential information about the company's business prospects and expansion plans, among

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1. In recent years, a number of news reports have surfaced detailing the exuberance individual investors have brought to the stock market. The *Boston Globe*, for example, ran a story in early 2000 detailing the stock market zeal of a group of taxi cab drivers working for Town Taxi. See Benjamin Wallace-Wells, *He Dispatches Cabs — And Stock Market Tips*, BOSTON GLOBE, Mar. 21, 2000, at A1.

2. See Investment Company Institute and Securities Industry Association, *Equity Ownership In America* 1 (Fall 1999), available at [http://www.ici.org/pdf/rpt\\_equity\\_owners.pdf](http://www.ici.org/pdf/rpt_equity_owners.pdf). The Investment Company Institute and the Securities Industry Association reported that the number of Americans owning stocks either directly or through a mutual fund increased from 42.4 million in 1983 to 78.7 million in 1999 (accounting for a 85.6 percent increase). See *id.* During the midst of the 1990s bull stock market, stock market investments accounted for forty percent of the average American family's net worth. See Kirstie Hamilton & Garth Alexander, *Summertime Blues*, SUNDAY TIMES, Aug. 9, 1998, § 3, at 8.

3. For example, the historical return on equity from 1926 to 1994 averaged 10.3% per year. See, e.g., Lynn Asinof, *Weekend Report: Check the Past When Investing for the Future*, WALL ST. J., Feb. 11, 1994, at C1. In contrast, the present average passbook savings annual interest rate is below 3%. See Thomas A. Fogarty, *Average Tax Refund Keeps Growing, But Should It?*, USA TODAY, Apr. 13, 2001, at 1B (noting that the present passbook savings rate is about 2.5%).

4. See Jeffrey M. Laderman et al., *The Epidemic of Insider Trading*, BUS. WK., Apr. 29, 1995, at 78 (quoting SEC Chairman Arthur Levitt as stating "[i]f the investor thinks he's not getting a fair shake, he's not going to invest, and that is going to hurt capital investment in the long run").

other things. Insiders may then exploit this information to profit from trades in the market at the expense of outside investors. The traded firm may also provide internal information to outside investors selectively; for example, giving nonpublic material information solely to a group of analysts that regularly follow the firm.<sup>5</sup>

Several sources of information advantage may also originate outside the traded firm. Market professionals command far more resources than any one individual investor.<sup>6</sup> Through their resource and expertise advantage, market professionals may determine more accurately whether the market price over or undervalues the traded firm's securities. An analyst, for example, may use its knowledge about the general economy, the industry sector, the movement of oil prices, and the political situation in the company's various worldwide markets, in combination with the securities filings information to estimate the company's overall value. Non-market professionals may also possess an information advantage with respect to the traded firm. Industry regulators about to impose new regulations on a particular company may possess nonpublic information pertaining to the new regulations material to the valuation of the company.<sup>7</sup> Newspaper reporters may possess material, nonpublic information obtained from their employment relevant to the valuation of a particular company.<sup>8</sup> Companies that interact with the traded firm, including suppliers, customers, and

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5. Recently, the SEC moved to curtail the ability of firms to make disclosures selectively to capital market participants under the newly promulgated Regulation FD. *See Selective Disclosure and Insider Trading*, 65 Fed. Reg. 51,716 (Aug. 24, 2000) (to be codified at 17 C.F.R. § 243.100-103) [hereinafter SEC, *Selective Disclosure and Insider Trading*]. *See infra* Section III.C (discussing Regulation FD); *see also* Stephen J. Choi, *Selective Disclosures in the Public Capital Markets*, 35 U.C. DAVIS L. REV. 533 (2002) (providing an analysis of Regulation FD); Zohar Goshen & Gideon Parchomovsky, *On Insider Trading, Markets, and "Negative" Property Rights in Information*, 87 VA. L. REV. 1229, 1268-73 (2001) (noting that selective disclosures may play a role in compensating specific analysts for providing the firm with monitoring of management, liquidity, and enhanced price efficiency).

6. Boston-based Fidelity Investments, for example, has nearly \$900 billion of managed assets. *See Fidelity Investments Introducing Two New Stock Funds*, BUS. WIRE, Dec. 21, 2000, available at Westlaw 12/21/00 Bus. Wire 10:59:00. Fidelity's large amount of managed assets allows Fidelity to spread the fixed costs of investment research, resulting in a lower per managed asset dollar research cost.

7. Elton "Butch" Bryan, the former Director of the West Virginia Lottery, for example, used his influence to ensure that Video Lottery Consultants would be selected as the sole manufacturer of video lottery machines for a planned expansion of such machines throughout West Virginia. Shortly after the decision to select Video Lottery Consultants, but before the public announcement of the selection, Bryan purchased 300 shares of Video Lottery Consultants stock. *See United States v. Bryan*, 58 F.3d 933, 937-39 (4th Cir. 1995).

8. R. Foster Winans, for example, was one of the writers of the *Wall Street Journal's* "Heard on the Street" column. Winans entered into a scheme with two brokers to provide information from the newspaper column on particular companies prior to publication. Based on the information, the two brokers then either purchased or sold securities in the featured companies. The net profits from the scheme totaled almost \$690,000. *See United States v. Carpenter*, 791 F.2d 1024, 1026-27 (2d Cir. 1986).

competitors, may also possess nonpublic information material to the valuation of the traded firm's securities.<sup>9</sup> For example, a biotech firm which knows it has just patented a particular gene may have a profitable opportunity to trade its rivals' shares short.<sup>10</sup>

In response to the potential harm uninformed investors face from informational disparities in the market, U.S. regulators have focused on the use of information in the public capital markets. The insider trading prohibitions under Rule 10b-5 of the Securities Exchange Act of 1934 ("Exchange Act") generally permit trading on the basis of deliberately acquired information advantages (which other market participants also had the opportunity to acquire).<sup>11</sup> Conversely, the securities laws often — although not uniformly — prohibit individuals from trading on information that is casually acquired through an investor's fiduciary position or privilege and not from a source readily available to all investors.<sup>12</sup> Insiders, for example, are prohibited from engaging in trades based on nonpublic material information casually acquired from the insiders' privileged fiduciary relationship with their own company.<sup>13</sup> Under the misappropriation doctrine, fiduciaries of an

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9. See Ian Ayres & Joseph Bankman, *Substitutes for Insider Trading*, 54 STAN. L. REV. 235, 241-42 (2001); Jill E. Fisch, *Start Making Sense: An Analysis and Proposal for Insider Trading Regulation*, 26 GA. L. REV. 179, 216-17 (1991) (noting that present insider trading prohibitions allow suppliers among other outside parties to trade on the securities of a firm based on confidential information obtained from the relationship).

10. Through short sales, an investor may sell shares that it does not own. To execute a short sale, the investor first borrows shares typically from a securities broker. The investor then sells the shares at the prevailing market price, promising to purchase shares in the future to repay the securities broker. Where the share price drops in value from the time of the initial sale to the time of the repurchase, the investor profits from the short sales.

11. Rule 10b-5 was promulgated under § 10 of the Securities Exchange Act of 1934. See Securities Exchange Act of 1934, 15 U.S.C. § 78(b) (2000).

12. Note that casually acquired information does not implicate the federal insider trading prohibitions absent a pre-existing fiduciary relationship. See, e.g., *SEC v. Switzer*, 590 F. Supp. 756 (W.D. Okla. 1984) (analyzing incident where Barry Switzer, at the time the University of Oklahoma football coach, overheard a conversation revealing nonpublic information and then traded based upon the information); see also Stephen M. Bainbridge, *Incorporating State Law Fiduciary Law Duties into the Federal Insider Trading Prohibition*, 52 WASH. & LEE L. REV. 1189, 1200-01 (1995) [hereinafter Bainbridge, *Incorporating State Law*] (arguing that the relevant fiduciary duty for insider trading liability is the "duty to refrain from self-dealing in nonpublic information"). For a discussion of the concept of casually acquired information, see Anthony T. Kronman, *Mistake, Disclosure, Information, and the Law of Contracts*, 7 J. LEGAL STUD. 1, 13, 18 (1978) (arguing that contract cases provide greater protection from the duty to disclose to "deliberately acquired information" compared with "casually acquired information"). Insiders of a corporation, for example, face a disclose or abstain duty when trading based on nonpublic material information obtained through their position as insiders of the corporation. See *infra* note 71 (discussing the disclose or abstain duty placed on corporate insiders).

13. For example, Ken Lay has notoriously been investigated for selling his Enron stock just before the company's collapse. See, e.g., <http://www.enronfraud.com/insider.html> (last visited Aug. 24, 2002); see also Section 10(b) of the Securities Exchange Act of 1934, 78 U.S.C. § 78j(b) (2000); Rule 10b-5, 17 C.F.R. § 240.10b-5 (2001). For a description of the application of insider trading prohibitions to actual corporate insiders, see A.C. Pritchard, HeinOnline -- 101 Mich. L. Rev. 316 2002-2003



outside source cannot free-ride on the source's effort by trading without the source's consent (or at least knowledge).<sup>14</sup>

Commentators have put forth several theories that justify (at least in part) the present securities law's focus on the source of the information and whether a trader acquires her information through deliberate hard work or casually through a fiduciary duty breach. Under one prominent theory, individuals should not be able to trade on casually acquired, "unerodable" information advantages.<sup>15</sup> Trades based on unerodable information, under this theory, reduce the confidence of uninformed investors and the willingness of such investors to put money into the capital markets.<sup>16</sup> Information obtained by outsider traders is erodable (and therefore tradeable) because any person had

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United States v. O'Hagan: *Agency Law and Justice Powell's Legacy for the Law of Insider Trading*, 78 B.U. L. REV. 13, 18-30 (1998).

14. The misappropriation theory originated with Chief Justice Burger's dissent in *United States v. Chiarella*, 445 U.S. 222, 240 (1980) (Burger, C.J., dissenting). Burger wrote that "a person who has misappropriated nonpublic information has an absolute duty to disclose that information or to refrain from trading." *Id.* at 240. Burger argued that persons trading on misappropriated information engage in "conduct [that] quite clearly serves no useful function except [their] own enrichment at the expense of others." *Id.* at 241. For a discussion of the misappropriation theory of insider trading liability, see *infra* Section III.A. Recently, for example, Merrill Lynch barred its analysts from purchasing shares of companies on which they provide coverage. See Gretchen Morgenson, *Brokerage Puts Limits on Stock Analysts*, N.Y. TIMES, July 11, 2001, at A1 (noting that the ban will cover 600 Merrill Lynch analysts worldwide but stating that it "fails to address the most significant area of conflict: the role that rhapsodic research reports can play in supporting the firm's lucrative investment banking business or in attracting new deals").

15. See Victor Brudney, *Insiders, Outsiders, and Information Advantages Under the Federal Securities Laws*, 93 HARV. L. REV. 322, 354 (1979) ("[T]he essential . . . element which makes an information advantage unusable by those who possess it in dealing with those who do not is the inability of the latter to overcome it lawfully, no matter how great may be their diligence or large their resources."); see also Pritchard, *supra* note 13, at 51 ("By limiting the misappropriation theory to information obtained in breach of a duty, the common law of agency protects individuals who have gained their information advantage through superior insight or hard work.").

Brudney adds a gloss to his definition of an unerodable advantage, arguing that unerodable information advantages are "not generally accumulated for use by its possessor in personal trading in securities . . . and therefore the incentive for personal gains from trading is not necessary to induce those few to pursue it." Brudney, *supra*, at 356. Analysts, nevertheless, with superior information and skill that generate proprietary information enjoy an unerodable advantage directly acquired with a view to trading profits. In response, Brudney narrows the scope of unerodable information advantages to cover primarily "unerodable information advantage[s] generally acquired for nontrading purposes . . ." *Id.* at 360-61. Brudney writes further that "there may nevertheless be systematic inequality of lawful access to information by reason of disparities among individual investors with respect to power, wealth, diligence, or intelligence. The values of efficiency in pricing and resource allocation served by encouraging pursuit of information about the worth of securities are diluted, if not destroyed, by a rule purporting to offset those disparities by requiring universal sharing of information." *Id.* at 360.

16. See Brudney, *supra* note 15, at 356 ("A rational buyer (or seller) in a market, who knows that the person with whom he is dealing has material information about the value of the product being exchanged which he could not lawfully acquire, will either refrain from dealing with the transactor or demand a risk premium.").

the opportunity to invest the effort in uncovering the valuable information.<sup>17</sup> We are all on a level information playing field when it comes to unearthing erodable pieces of information, and market competition will mean that advantages based on such information will quickly erode as the information is incorporated into the stock price. In contrast, in a world where markets are not strong form efficient,<sup>18</sup> outsiders do not have an opportunity to erode the information advantage of insiders with superior information. Explicitly referring to the need to stem “unerodable information advantages,” the Securities and Exchange Commission (“SEC”) designed Regulation FD to curtail the ability of companies to provide nonpublic material information selectively to favored outside investors and market professionals.<sup>19</sup> Stock analysts can trade on information that they work to obtain, but the rules work to stop analyst trading on the basis of information that is bestowed on them by the firm itself. The recently promulgated SEC

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17. See *id.* at 341. Brudney’s theory of unerodable information advantages is similar but not identical to the parity-of-information theory initially espoused by the Second Circuit. The parity-of-information theory requires that all investors have access to the same information. Under the parity-of-information theory, an investor must either abstain from trading or disclose any material information known only to the investor but not to the public market. See, e.g., *SEC v. Texas Gulf Sulphur*, 401 F.2d 833, 848 (2d Cir. 1968) (holding that Rule 10b-5 “is based in policy on the justifiable expectation of the securities marketplace that all investors trading on impersonal exchanges have relatively equal access to material information”); see also Joel Seligman, *The Reformulation of Federal Securities Law Concerning Nonpublic Information*, 73 GEO. L.J. 1083 (1985) (advocating a parity-of-information approach). The Supreme Court later rejected the parity-of-information theory in *United States v. Chiarella*, 445 U.S. at 234-35. In contrast, Brudney’s unerodable advantages theory would allow outside investors who obtain a nonpublic material advantage through their own hard work and not through position or privilege to profit from such information. See Brudney, *supra* note 15, at 341; Joel Seligman, *A Mature Synthesis: O’Hagan Resolves “Insider” Trading’s Most Vexing Problems*, 23 DEL. J. CORP. L. 1, 4, 5 n.27 (1998).

18. Several versions of the efficient market hypothesis exist. The strong form of the hypothesis holds that all information, whether public or nonpublic, is incorporated in the secondary market securities price. The semistrong version of the efficient capital markets hypothesis in turn posits that the secondary market price of companies reflects all publicly available information on the company. In contrast, the weak form version of market efficiency posits only that the market price reflects all prior price information. See Eugene F. Fama, *Efficient Capital Markets: A Review of Theory and Empirical Work*, 25 J. FIN. 383 (1970) (providing a survey of theoretical implications of efficient markets and empirical testing of the efficient markets hypothesis); see also Daniel R. Fischel, *Efficient Capital Markets, the Crash, and the Fraud in the Market Theory*, 74 CORNELL L. REV. 907, 911, 912 n.11 (“The empirical evidence to date (with some exceptions) appears to establish the validity of the weak and semistrong but not the strong form of the efficient capital markets hypothesis.”). Unless otherwise specified, this Article utilizes the term “efficient market” to refer to a trading market that displays features of a semistrong efficient market.

19. See SEC, *Selective Disclosure and Insider Trading*, *supra* note 5, at 51,716 (stating that “selective disclosure has an adverse impact on market integrity that is similar to the adverse impact from illegal insider trading: Investors lose confidence in the fairness of the markets when they know that other participants may exploit ‘unerodable information advantages’ derived not from hard work or insights, but from their access to corporate insiders”). For a view critical of the confidence in the market argument, see Bainbridge, *Incorporating State Law*, *supra* note 12, at 1241-45.

rules under Regulation FD also resonate with the Lockean notion of desert under which a person enjoys a natural right to the results of her labor.<sup>20</sup>

This Article comes to bury the concept of unerodable advantage as the basis for regulating informationally driven trades.<sup>21</sup> The distinction between erodable and unerodable advantages is to our minds unworkable in practice,<sup>22</sup> but more importantly, it is not sufficiently con-

20. See JOHN LOCKE, *The Second Treatise* § 27, in TWO TREATISES OF GOVERNMENT (Peter Laslett ed., Cambridge Univ. Press 1970) (1690) [hereinafter LOCKE, *The Second Treatise* § 27, in TWO TREATISES]:

Though the earth and all inferior creatures be common to all men, yet every man has a property in his own person; this, nobody has any right to but himself. The labour of his body and the work of his hands we may say are properly his. Whatsoever, then, he removes out of the state that nature hath provided and left it in, he hath mixed his labour with, and joined to it something that is his own, and thereby makes it his property. It being by him removed from the common state nature placed it in, it hath by this labour something annexed to it that excludes the common right of other men. For this labour being the unquestionable property of the labourer, no man but he can have a right to what that is once joined to, at least where there is enough, and as good left in common for others.

*Id.* The Lockean notion of just deserts is used frequently in the intellectual property literature. See Wendy J. Gordon, *A Property Right in Self-Expression: Equality and Individualism in the Natural Law of Intellectual Property*, 102 YALE L.J. 1533 (1993).

21. Commentators have also advanced the theory that the insider trading prohibitions should work to protect the property rights of those that invest in creating information. See Stephen M. Bainbridge, *Insider Trading Regulation: The Path Dependent Choice Between Property Rights and Securities Fraud*, 52 SMU L. REV. 1589 (1999) [hereinafter Bainbridge, *Insider Trading Regulation*] (propounding a property rights rationale to justify the misappropriation theory of insider trading). And the law, by prohibiting agent trading, protects the principal's property in the information from being eroded — thus enhancing the principal's incentive to expend effort to unearth the information in the first place.

Other approaches to insider trading exist. None, however, as a positive matter explains present insider trading doctrine as well as the unerodable advantage or property rights theories. See *supra* note 17 (discussing the parity-of-information theory); see also Fisch, *supra* note 9, at 184 (arguing that insider trading liability should focus on insider "status" rather than on the presence of fiduciary duties); Roberta S. Karmel, *Outsider Trading on Confidential Information — A Breach in Search of a Duty*, 20 CARDOZO L. REV. 83 (1998) (advocating that insider trading prohibitions exist to complement mandatory disclosure requirements imposed under the securities laws); Alan Strudler & Eric W. Orts, *Moral Principle in the Law of Insider Trading*, 78 TEXAS L. REV. 375 (1999) (providing a moral argument against insider trading). In providing a unified framework to assess the merits of informational advantages in the securities markets, we assess and ultimately reject these approaches as well. See *infra* Part III.

22. Many forms of unerodable information advantages exist unregulated in the market today. Insiders in rivals firms are free to trade with impunity on the stock of a competitor even though their informational disparity was casually acquired and even though other market participants did not have a credible opportunity independently to acquire the information. See Ayres & Bankman, *supra* note 9, at 24. And an investor with particularly good investment acumen will always enjoy a trading advantage over investors without such expertise. Larger, more professional investors will always enjoy a resource advantage over smaller investors who make only insignificant investments in the capital markets. Smaller, individual investors will never find it feasible to overcome such advantages. Frank Easterbrook originally made the observation that all information advantages require some amount of costly expenditures. Because investors vary in the cost function they face to obtain information, due to skill, wealth, and human capital differences, no investors are truly equal in their access to information. See Frank H. Easterbrook, *Insider Trading, Secret Agents, Evidentiary Privileges and the Production of Information*, 1981 SUP. CT. REV. 309, HeinOnline -- 101 Mich. L. Rev. 319 2002-2003

nected to either efficiency or equity. Even the use of unerodable information advantages in securities transactions may result in a net social benefit. Managers engaged in insider trading may very well benefit from their unerodable advantage at the expense of uninformed investors. Nevertheless, the use of such insider information may alter the securities market price, resulting in increased price accuracy.<sup>23</sup> Similarly, shareholders may benefit both from the reduced direct compensation necessary to attract the manager as well as from the increased incentives to maximize share value that the manager may experience from the ability to engage in insider trading.<sup>24</sup> Conversely, the use of erodable information advantages in securities transactions may generate a net social loss. Competition between investors to gain a brief information advantage may create duplicative research costs, for instance.

This Article instead proposes a common framework to assess all forms of informational disparities. From a social welfare perspective, informational disparities have similar impacts. On the one hand, informational disparities certainly raise the cost to uninformed traders. To the extent a trader lacks information, the trader will suffer systematically reduced returns compared with more informed investors. Investors seeking an information advantage as well may expend costly resources doing so. On the other hand, the same informational disparities may generate benefits. The trading losses of uninformed investors translate directly into trading profits for the informed traders. Trades based on an information advantage will also result in an increase in overall securities price accuracy regardless of the source of the advantage.

Applying the framework, the Article shows that the informed outsider<sup>25</sup> fails to internalize the social impacts of her trading. She compares her expected profits from informed trading to her expected costs of acquiring the information — and ignores, *inter alia*, the

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330. Coming from the opposite perspective, Krawiec argues that at some level investors enjoy access to all information, including even insider information. For example, a person may work hard to become a corporate officer and then director to obtain even inside information. See Kimberly D. Krawiec, *Fairness, Efficiency, and Insider Trading: Deconstructing the Coin of the Realm in the Information Age*, 95 NW. U. L. REV. 443, 478 (2001).

23. See, e.g., Edmund W. Kitch, *The Law and Economics of Rights in Valuable Information*, 9 J. LEGAL STUD. 683, 719 (1980) (arguing that the prohibition against insider trading has resulted in less efficient securities market prices); Henry G. Manne, *Insider Trading and the Law Professors*, 23 VAND. L. REV. 547, 565-76 (1970) (contending that insider trading increases the accuracy of securities market prices).

24. This Article later discusses the positive impacts on corporate welfare from allowing insider trading. See text accompanying notes 75-77.

25. See *SEC v. Clark*, 915 F.2d 439, 443 (9th Cir. 1990) (defining “outsiders” as “persons who are neither insiders of the companies whose shares are being traded, nor tippees of such insiders”).

impact on stock price accuracy or the costs to the other side (consisting of uninformed investors) of the transaction.

Just like a polluter who fails to internalize the social impact of its pollution, the outsider trader is not well placed to decide whether informed trading enhances social welfare. We will argue that outsider trading can produce externalized costs that the outsider ignores in deciding to trade. Informed outsider trading will predictably increase the bid-ask spread that shareholders of a traded firm must bear as a transaction cost of buying and selling their positions. Informed outsider trading can also distort the decisionmaking of the traded firm. A traded firm seeking to protect its shareholders from the transfers worked by informed traders may inefficiently rush the disclosure of information that would be more beneficially delayed absent the outsider trading. And more generally, informed trading by taxing the net profitability of share ownership can dampen the incentives for optimal decisionmaking. It is well understood that residual claimants — who capture the marginal profits — are often well placed to control the firm. But outsider traders capture some of the residual profits (through trades with more uninformed shareholders) and thereby can blunt shareholders incentives to maximize firm value.

If anything, a stronger argument therefore exists for the mandatory regulation of outsider trading advantages than for insider trading.<sup>26</sup> Henry Manne's seminal work in the 1960s, for example, recognized that traded firms internalize the effects of insider trading upon their investors.<sup>27</sup> Building on that insight, Manne argued that the securities laws should not ban insider trading; he instead contended that the traded firm would design an insider trading policy that maximized the value to its own shareholders.<sup>28</sup> Compared with the traded firm, outsider traders do not internalize the impact of their actions on uninformed investors. Instead of prohibiting insider trading and permitting outsider trading, Manne could have argued that the law got it just backward: it might be more efficient for the law presumptively to prohibit outsider trading (because outsiders do not internalize many of the important social costs when deciding whether to trade), but to allow insiders to trade with the consent of their employers.

Rather than assess the various costs and benefits of engaging in the mandatory regulation of different forms of informational disparities directly, this Article adopts a different approach, arguing that regula-

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26. On the other hand, problems with managerial opportunism may loom larger for insider trading as opposed to outsider trading. We discuss the problem of managerial opportunism with respect to outsider trading in Section IV.A.2. The relative lack of managerial opportunism related to outsider trading, we argue, provides policymakers with the option of relying more on the traded firm to internalize the impacts of outsider trading.

27. See HENRY G. MANNE, *INSIDER TRADING AND THE STOCK MARKET* (1966).

28. See *id.*

tors ask the wrong question in focusing on whether an information advantage is unerodable. Regulators should instead pose the question of *which actor* should determine what information advantages are allowable in the capital markets. Regulators should leave this decision to market participants that *internalize* the various social effects of informed trading. The task of regulators then becomes assisting market participants in internalizing the impacts from the creation and use of informational disparities.

Outsider traders individually fail to internalize all the effects of informed trades. One market participant, however, already does internalize many of the impacts from a particular type of information advantage: the traded firm. The present securities law can be viewed as having two independent facets: (1) permitting outsider trading (based on an erodable information advantage) and (2) assigning the rights to control whether outsider trading takes place to the source of the information. This second facet is rarely discussed and in some ways seems an inevitable implication of the first facet. Only the person with the information would know that she had a trading opportunity. And we cannot conceive of a rule that could effectively force an informed outsider to trade on her information. But it is possible to *grant a non-source the right to block such informed trading*.<sup>29</sup>

Indeed, the thesis of this Article is that regulators should allow the traded firm to block informed trading in its securities. Unlike the current regime that grants outsiders *laissez faire* trading rights, our proposal reassigns the outsider trading rights to the traded firm itself.<sup>30</sup> The traded firm may then (a) generally waive its rights to control informed outsider trading, (b) impose restrictions or prohibitions on informed outsider trading, (c) sell the right to engage in informed trades to any market participant(s) of its choosing, or (d) even subsidize outsiders to encourage them to engage in informed trading. Under this regime, the traded firm, which internalizes many of the costs and benefits from the outsider traders' decision to engage in information research, will have an incentive to design the optimal information research policy for its own particular situation.

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29. In contrast, Goshen and Parchomovsky talk about "negative" property rights in information that they argue the legal regime should grant to insiders at least with regards to inside information. Under such a negative property rights regime, insiders are denied the ability to use their inside information to profit from securities trades, thereby providing outside analysts a greater ability to profit from the analysts' own external research efforts. See Goshen & Parchomovsky, *supra* note 5, at 1266-69. Under Goshen and Parchomovsky's conception of negative property rights, insiders may not trade with outside analysts to relieve the insiders of their negative property right. See *id.*

30. Following the framework of Wesley Hohfeld, our proposal assigns the right to engage in outsider trading to the traded firm. All outside investors then owe a corresponding duty to the traded firm not to engage in such outsider trading without the permission of the firm. See, e.g., Wesley Newcomb Hohfeld, *Some Fundamental Legal Conceptions as Applied in Judicial Reasoning*, 23 YALE L.J. 16, 30 (1913).

Informed trading that is good for the traded firm is likely to be good for society — thus our proposal crucially gives the traded firm control over whether particular types of such trading can go forward. Granting the traded firm the right to block informed trading is more efficient than the current regime which gives outsider traders sole discretion whether to trade both because (1) in the absence of Coasean negotiations,<sup>31</sup> the traded firm is better situated to decide whether particular classes of trades are on net socially beneficial, and (2) Coasean negotiations (which more fully guarantee through mutual consent that only beneficial trades proceed) become themselves more likely. Re-assigning the trading rights from the owner of the information (the source) to the traded firm is more likely to facilitate a Coasean trade. Under the current regime, a traded firm that wanted to limit a certain class of outsider trading (based on superior information) would need to identify and negotiate with an amorphous and replenishing class of potential stock analysts. In contrast, under our proposed regime, it is much cheaper for potential traders to identify and negotiate with the firm on which they wish to undertake deliberate research.

It might initially appear to be unfair to reassign to the traded firm the right to control whether an outsider can trade. It is the outsider's information after all, and she should be able to do whatever she wants with it. But this argument does not withstand analysis. The stock analyst may own the information, but mere ownership of information does not necessarily translate into laissez faire trading rights in somebody else's firm. If Carleton learns that there is gold on Fischel's land, Carleton may own the information — but he does not perforce have a right to go onto Fischel's land and start mining. More importantly, Carleton does not have an unimpeded right to buy Fischel's land on the cheap. Fischel has the right to demand a representation from Carleton that the sale is not being motivated by particular kinds of information advantage. We will refer to this as the "Laidlaw right" of uninformed traders.<sup>32</sup> We are so inured to the unrestricted trading of

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31. The term "Coasean" refers to Ronald Coase's classic argument that the location of a legal entitlement does not matter from an efficiency perspective to the extent that affected parties may costlessly negotiate and reallocate the entitlement, among other conditions. See Ronald H. Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1 (1960).

32. In the well-known contracts case of *Laidlaw v. Organ*, 15 U.S. (2 Wheat.) 178 (1817), a similar situation arose. Organ possessed information that the signing of the Treaty of Ghent (ending the war of 1812) would soon raise the British naval blockade, increasing the value of tobacco among other goods. Organ purchased tobacco from Peter Laidlaw & Co. Before completing the purchase, an employee of Laidlaw asked "if there was any news which was calculated to enhance the price or value of the article about to be purchased." *Id.* at 183. While Chief Justice Marshall writing for the Supreme Court held that Organ ordinarily had no duty to disclose the information to Laidlaw because the information was "equally accessible to both parties," *id.* at 195, he remanded the case to determine whether there had been "overreaching," given that Laidlaw had asked the question (and received no response). *Id.*

stock that it is difficult to remember that an organizing firm surely has an equitable right to set up rules restricting or conditioning the transferability of its securities in ways that accrue to the benefit of its shareholders.<sup>33</sup> And there is evidence in large block trades that uninformed traders require representations from the other side that they are not trading on the basis of nonpublic information.<sup>34</sup>

In crafting a proposal that grants the traded firm an alienable right to control the extent of informed trading, it is important to specify clearly the default (that will govern if the traded firm remains silent) and “opt out” rules (that determine whether the traded firm has privately varied the default class of allowable trades). We propose retaining the current trading restrictions as defaults. Insiders would be prohibited from trading on the basis of nonpublic information, but outsiders as a general matter would — in the absence of a traded firm opt out — be allowed to trade. However, unlike the current trading restrictions that tend to be mandatory rules, our focus on internalization militates toward default rules that would allow the traded firm to decide whether a particular class of informed trading was beneficial.<sup>35</sup> Thus, we would allow a traded firm to opt out of many of the traditional mandatory restrictions against informed trading or opt into additional restrictions against informed trading by outsiders — even those who are not in privity with the traded firm — who presumptively could (and under current law can) trade with impunity.<sup>36</sup>

A thorough appreciation of internalization thus undermines the foregoing theory of “unerodable advantage” as a basis for prohibiting informed trading. Our proffered system of default trading restrictions (and default trading permissions) would, like the proposals of Manne and his followers, allow insiders to contract for the right to trade on the basis of material, nonpublic information. But even if readers pre-

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33. For a discussion of the ability of a firm to impose trading restriction on its own stock, see *infra* Section IV.B.2.

34. Conversation with Professor Steve Thel, Fordham Law School in New York, N.Y. (Feb. 8, 2002).

35. Note that trading restrictions placed on outsiders under the misappropriation theory of insider trading are not necessarily immutable. Because the misappropriation theory depends on a breach of a fiduciary duty owed to the source of the information, the source in theory could shield outsiders from insider trading liability simply by sanctioning such trades. Indeed, the Supreme Court in *O'Hagan* indicated that the mere disclosure on the part of an outsider trader to the source that she will engage in trades based on the source's information eliminates deception and therefore the possibility of insider trading liability even where the source does not condone such trades. See *United States v. O'Hagan*, 521 U.S. 643, 655 (1997).

36. Present mandatory restrictions against informed outsider trading include the misappropriation theory of insider trading prohibitions and Rule 14e-3 of the Exchange Act's limits on the ability of any trader other than the acquirer to trade on nonpublic material information related to a tender offer. We would prohibit traded firms from opting out of Rule 14e-3 because of our concerns with managerial entrenchment and self-dealing. For a discussion of present limits on informed trading, see *infra* Part III.



fer not to make insider trading contractible, they should still be willing to make outsider trading contractible.<sup>37</sup> Indeed, there are even stronger reasons to worry that unregulated outsider trading on the basis of material nonpublic information will impose uncompensated costs on the traded firm that exceed the external benefits of such trading. Traded firms would have strong incentives not to impose overbroad trading restrictions that reduced their shareholders' liquidity — we even foresee that some firms would directly or indirectly subsidize informed outsider trading. But we see no reason why an issuing firm should not have the right to expand the scope of Rule 14e-3 of the Exchange Act to restrict informed outsider trading on the basis of nonpublic patent information or block rivals from speculating on the basis of nonpublic information.<sup>38</sup>

Traded firms already have considerable freedom to restrict the ability of informed traders to profit at the expense of the uninformed.<sup>39</sup> We will show that issuing restricted stock can serve to limit outsiders' unfettered ability to profit on material, nonpublic information. However, such restrictions are rarely if ever imposed. Instead of arguing that firms have simply failed to think about the utility of such restrictions or the means of implementation, we believe it would be useful for the government to adopt policies that make clear that such restrictions are contemplated by law and that facilitate their adoption and enforcement. Traded firms can as a formal legal matter privately restrict some types of outside informed trading, but they do not currently have the power to restrict informed trading on options or future markets or to contract for public investigation and criminal prosecution of such violations. To wit, when we describe our proposal in more detail, we will suggest a menu system of opt outs that grant traded firms more flexibility in tailoring the class of outsider trading which is restricted and the type of restrictions which are imposed. Moreover, the SEC should make clear that both its investigative and enforcement resources would be brought to bear against violations of the re-

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37. As we discuss later in the Article, the risk of managerial self-dealing through outsider trading is much reduced compared with insider trading. Even where managerial self-dealing may pose a problem, specific exclusions are possible as we discuss *infra* in Section IV.A.2.

38. For Rule 14e-3, see General Rules and Regulations, Securities Exchange Act of 1934, 17 C.F.R. § 240, 14e-3 (2001). Rule 14e-3 prohibits trades based on material information related to a tender offer where the person engaging in the trade “knows or has reason to know” that the information is nonpublic and the person “knows or has reason to know [the information] has been acquired directly or indirectly from (1) the offering person; (2) the issuer of the securities sought or to be sought by such tender offer, or (3) any officer, director, partner or employee or any other person acting on behalf of the offering person or such issuer.” *Id.* Among other things, Rule 14e-3 excludes the acquirer from its scope. *See id.*

39. *See infra* Section IV.B.2 (discussing the ability of traded firms under present law to restrict trading in their own securities).

strictions announced by the traded firms, perhaps charging a fee to the traded firm for such services.<sup>40</sup>

There are two important limitations to our proposal which themselves are natural outgrowths of our internalization theory. First, regulators should scrutinize whether a traded firm's restrictions on outsider trading are a by-product of managerial self dealing. Our internalization result fails if the traded firm's decisions are motivated by managerial interests instead of those shareholders. In particular, we worry that managers may use restrictions on informed outsider trading to make it harder for third-parties to mount tender offers or to make it more difficult for shareholders to find out about managers' mis- or malfeasance. But as with takeover defenses, the optimal response is not to completely eliminate managerial discretion. Instead, we propose a combination of limits on the types of trading restrictions that managers can impose and heightened judicial scrutiny of those restrictions that raise self-dealing concerns.

Second, regulators should scrutinize whether particular types of trading restrictions sacrifice third-party pricing benefits. Our internalization result can fail if outsider trading produces third-party benefits that are external to the combined interests of both the outside trader and the traded firm. Investments in information that have allocational spillover effects for other decisionmakers may produce net social benefits even though they harm the private interests of the traded firm. As with the self-dealing concern, however, the optimal response is not to completely eliminate the rights of traded firms to control outsider trading. Indeed, no one who supports Rule 14e-3's ban on trades based on tender offer-related information can simultaneously believe that unregulated outsider trading always produces net social benefits. Instead of giving outsiders unfettered freedom to engage in informed trading or giving traded firms unfettered freedom to block informed trading, we propose limiting the types of trading restrictions that traded firms can impose to circumstances in which external pricing benefits are likely to be less important. At a minimum, we believe that traded firms should have the freedom to prevent what we call "informational frontrunning" in which outsiders profit from trading on non-public information (such as quarterly sales) which by law are about to be publicly released.

Part II of this Article establishes a framework to consider the various impacts to market participants and society from information research into securities prices. Part III assesses the current approach securities laws take toward informational disparities. Part IV sets forth this Article's internalization proposal giving traded companies a prop-

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40. The costs of government enforcement are of course real expenditures. Through a fee, the government may force the traded firm to internalize such costs.

erty right to control whether informed trades in their shares take place.

## II. AN INTERNALIZATION MODEL OF INFORMATIONAL DISPARITY

When one investor holds an information advantage with respect to a particular security, the investor will enjoy systematically greater returns than uninformed traders. Insiders that trade on nonpublic information obtained from their company, for example, will profit at the expense of the rest of the market. Likewise, smaller, uninformed investors trade at a disadvantage relative to larger, financial institutions with the resources to engage in detailed securities research.<sup>41</sup> Despite the loss to uninformed shareholders from informed trades, other parties nevertheless may gain when an investor engages in informed trades. To the extent securities prices become more accurate as a result of the trades, market participants that depend on accurate prices will benefit.

The informed trader obviously internalizes the benefits of the expected trading profits. But these are private and not social benefits because they are exactly offset by losses to the uninformed trader. This part shows that the social costs and benefits of informed trading — which on net may be either positive or negative — are largely borne by others and hence external to the informed trader's calculus in deciding whether or not to trade. The only substantial social cost borne by the informed trader concerns the expenditures that she may incur to acquire the nonpublic information. Outsider traders compare whether the private transfer benefit of such trading is greater than the private (and social) research costs of acquiring information — and not whether such trading is on net socially beneficial. From a societal viewpoint, therefore, informed traders (whether insiders or outsiders), if left to their own devices under a completely *laissez-faire* market system, may engage in either too much or too little research.

Section (A) sets forth a framework to assess the different impacts of the creation and use of information in securities market transactions from the perspective of overall social welfare. Using this framework, Section (B) applies the framework to analyze the regulation of insider trading. Section (C) then uses the framework to assess the desirability of regulating outsider trading that involves an informational disparity.

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41. *See supra* note 6.

### A. *Disaggregating the Internal and External Impacts of an Information Advantage*

Imagine first a market where investors all possess the same set of information and have the same estimates of the value of particular securities. Moreover, the investors are unable to improve on their information or estimates and thus, enjoy an equal playing field with respect to knowledge about securities market valuations. In such a market, each investor will have no better information than the securities market price as to the value of the traded firm. Given a particular price, the traded firm is just as likely to be over as undervalued. Without any additional knowledge, therefore, executing a trade in the traded firm's securities will, on average, not change the net worth of the trader. Instead, only traders that seek to rebalance their portfolio or that need to obtain cash will seek to sell securities in such a situation. A liquidity trader, for example, may need to sell shares to raise money to pay for a house, car, or other consumption good.<sup>42</sup> As liquidity traders execute orders in the market, the market will not treat individual trading transactions as a signal about the valuation of the traded firm. Rather, the market price will adjust discontinuously as the entire market learns of new information from non-trading sources, for example through SEC filings on the part of the traded firm.<sup>43</sup>

Now introduce the possibility that investors may obtain information on the traded firm that provides the investors with an advantage over uninformed investors. At least four distinct effects result from the decision on the part of an investor to obtain an information advantage: (1) the investor must make an expenditure of resources to obtain the information as well as cover transaction costs (brokerage fees, for example); (2) the investor gains an information advantage in its securities trades leading to a systematically higher return; (3) other uninformed investors bear a cost to the extent they expect to take opposite positions with informed traders (as well as transaction costs); and

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42. See, e.g., Douglas W. Diamond & Robert E. Verrecchia, *Information Aggregation in a Noisy Rational Expectations Economy*, 9 J. FIN. ECON. 221, 234 (1981); Milton Harris & Arthur Raviv, *Differences of Opinion Make a Horse Race*, 6 REV. FIN. STUD. 473, 474 (1993). For a model of the interaction between informed investors, liquidity traders, and a market specialist, see Albert S. Kyle, *Continuous Auctions and Insider Trading*, 53 ECONOMETRICA 1315 (1985).

43. See Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 568-69 (1984) (noting that prices adjust "rapidly and with near perfect dynamic efficiency" in situations where all become "universally informed" to information at once). On the other hand, Gilson and Kraakman note that many traders lack the sophistication to determine the significance of "technical accounting information" contained in mandatory information disclosure. *Id.* at 569. Thus, new financial information contained in a SEC filing may result in a more gradual price response. See *id.* at 569-70 (contending that "[t]he rapidity of such price adjustments depends on the volume of informed trading").

(4) investors and other market participants may experience other costs and benefits associated with the informed trades.

The first two effects of information research relate to the investor making the decision to engage in information research. First, an investor seeking an information advantage in trading securities must expend her own time and resources. An investment analyst may spend effort to analyze a firm's recent securities disclosure filings and to integrate such information with other information obtained from various sources to obtain a richer picture of a company's valuation. Likewise, an investor who seeks to obtain an information advantage through the theft of such information from another source of information must expend resources in engineering the theft.<sup>44</sup>

Second, the investor who obtains an information advantage will benefit from this advantage through securities transactions. An analyst with an information advantage may either engage in proprietary trades or sell this advantage to other investors. Misappropriators may use their purloined information advantage to engage in trades to their own financial benefit. Armed with the knowledge that a company is overvalued, for example, an investor may sell the securities of the company short.

In deciding whether to engage in research, however, the investor may ignore impacts from the decision to engage in information research on other market participants. The third effect this Article addresses involves the cost to uninformed traders from informed trades. Informed traders will not directly take into account the cost they impose on uninformed investors. Indeed, the very benefit which informed traders seek to obtain is derived from the loss uninformed traders suffer. Those uninformed investors who planned to trade for liquidity reasons regardless of the market price will not directly suffer harm, of course. Consider a situation where the market undervalues the traded firm's securities. Whether a liquidity trader sells securities at an undervalued price to the informed investor or to another uninformed investor, the liquidity trader will lose to the extent of the undervaluation.

Nevertheless, identifiable subsets of uninformed investors exist that will lose because of their informational disadvantage. A range of uninformed investors, for example, may offer to trade a certain volume of securities at the current market price; some investors may offer to sell to obtain cash while others may seek to purchase to rebalance their portfolios. Now introduce an informed investor who

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44. A newspaper reporter, for example, who seeks to use information from an upcoming article to engage in informed securities trades must exert effort in obtaining assignments that may lead to such informative articles as well as in hiding her trades from the newspaper itself. See *supra* note 8 (detailing the insider trading scheme of a *Wall Street Journal* reporter).

realizes the traded firm's securities are undervalued and therefore seeks to purchase securities. The increased purchase orders on the part of the informed investor may displace uninformed investors who would have otherwise purchased the offered securities. Assume, for example, that the increased purchase orders cause the market price to rise.<sup>45</sup> To the extent the informed investor's purchase orders alter the market price, some uninformed investors who otherwise would not have engaged in such a transaction may be induced into selling their securities.<sup>46</sup> Likewise, investors who planned to purchase securities at the previous lower market price may choose to forego such transactions after the informed investor's purchase orders raise the market price.<sup>47</sup>

Significantly, the trading benefit that informed traders receive from their information advantage will exactly equal the trading loss to uninformed investors.<sup>48</sup> To the extent a fixed amount of securities exist in the secondary market for any one traded firm, the purchase of undervalued securities at a discount necessarily requires the sale of such securities from another investor. Likewise the sale of overvalued securities at too high a price requires the presence of other investors willing to purchase the securities.

This Article's fourth informational effect focuses on other consequences of informed trades for market participants. As with the direct trading loss to uninformed investors, informed investors may not take into account the impact on other market participants from their in-

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45. Increased purchase orders may cause the market price to increase for two separate reasons. First, more purchase orders may signal to the market that informed investors believe the market price is presently undervalued. Reacting to this signal, market makers among others may increase the bid-ask price for the particular securities. Second, increased demand may place pressure on the price where an upward sloping supply curve exists for shares. An upward sloping supply curve may exist, for example, because investors have different expectations as to share value or because investors vary in the tax impact from selling their shares. For a discussion of the possible reasons why an upward sloping supply curve may exist in the securities markets, see Stephen J. Choi & Eric L. Talley, *Playing Favorites with Shareholders*, 75 S. CAL. L. REV. 271, 346-47 (2002). For a discussion of empirical studies demonstrating an upward sloping supply curve for shares, see Jesse M. Fried, *Insider Signaling and Insider Trading With Repurchase Tender Offers*, 67 U. CHI. L. REV. 421, 434-35, n.65-67 (2000).

46. See, e.g., William K.S. Wang, *Trading on Material Nonpublic Information on Impersonal Stock Markets: Who is Harmed, and Who Can Sue Whom Under SEC Rule 10b-5?*, 54 S. CAL. L. REV. 1217, 1235-40 (1981) [hereinafter Wang, *Trading on Material Nonpublic Information*].

47. See, e.g., William K.S. Wang, *Stock Market Insider Trading: Victims, Violators and Remedies — Including An Analogy to Fraud in the Sale of a Used Car With a Generic Defect*, 45 VILL. L. REV. 27, 34-35 (2000) [hereinafter Wang, *Stock Market Insider Trading*]. Wang also makes the observation that uninformed traders who engage in more frequent transactions are systematically more disadvantaged from the presence of investors with an information advantage. See *id.* at 37-40.

48. See Wang, *Trading on Material Nonpublic Information*, *supra* note 46, at 1234-35 (setting forth the "Law of Conservation of Securities").

formed trades. Stock price accuracy for the traded firm, for instance, is potentially increased through the existence of informed trading.<sup>49</sup> To the extent the market correctly deciphers the informational content behind trades on average, more informed trades will result in an increase in stock price accuracy.<sup>50</sup> For example, the market may view a large volume of sell orders from an insider as providing negative information as to the insider's company valuation.<sup>51</sup> Conversely, when Warren Buffett announces that he has made a large investment in a particular company, the market may react positively to such information.<sup>52</sup>

Greater stock price accuracy, in turn, may benefit the traded firm's shareholders as well as third parties. For undiversified shareholders, greater share price accuracy reduces the risk that the shareholders may hold overvalued securities. Employees of the traded firm, for example, are frequently undiversified in their risk with respect to the traded firm's stock.<sup>53</sup> Individual investors also often hold undiversified portfolios.<sup>54</sup> Even for diversified shareholders, informed trades that

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49. On the other hand, an argument exists that informed insider trading may not increase overall price accuracy to the extent such trades reduce the incentives of outside investors to engage in research. See Michael J. Fishman & Kathleen M. Hagerty, *Insider Trading and the Efficiency of Stock Prices*, 23 RAND J. ECON. 106 (1992); Naveen Khanna et al., *Insider Trading, Outside Search & Resource Allocation: Why Firms and Society May Disagree on Insider Trading Restrictions*, 7 REV. FIN. STUD. 575 (1994). In deciding whether to allow insider or outsider trading, a firm that internalizes most of the benefits from increased stock price accuracy, nevertheless, will balance the value of allowing either form of trading.

50. The market, of course, may have more difficulty in deciphering the informational content behind any one trade. On average, however, the market should interpret the signal from trades in an unbiased fashion. Moreover, given that information on the identity of the trader combined with the size of the trade is available, the market will have an increased ability to interpret the information behind any specific trade.

51. See Aswath Damodaran & Crocker H. Liu, *Insider Trading as a Signal of Private Information*, 6 REV. FIN. STUD. 79 (1993); H. Nejat Seyhuan, *Insiders' Profits, Costs of Trading, and Market Efficiency*, 16 J. FIN. ECON. 189, 196 (1986) (finding that months where insiders sell shares on net are followed by an average 100-day abnormal return of -1.7%).

52. Warren Buffett, an extremely successful investor from Omaha, Nebraska, is often written about within the financial press. For an exemplary article, see Carol J. Loomis, *The Value Machine*, FORTUNE, Feb. 19, 2001, at 70.

53. See Pui-Wing Tam, *Hard Drive: Why Tech-Stock Junkies, Despite Advice, Often Fail to Diversify*, WALL ST. J., Jan. 6, 1999, at C1 (reporting that in many 401(k) retirement plans, employees hold thirty percent of their money in their own company's stock); see also Merritt B. Fox, *Required Disclosure and Corporate Governance*, 62 LAW & CONTEMP. PROBS., Summer 1999, at 113, 121 n.16 [hereinafter Fox, *Required Disclosure*] (citing an unpublished study by Randall Kroszner showing that "a reduction in the riskiness of an issuer's stock will increase the proportion of stock-based compensation that a manager is willing to accept").

54. See Tam, *supra* note 53, at C1 (stating that "many individuals now are dangerously undiversified in their investments" particularly in high technology stocks). Indeed, in recent years, many investment web sites have advocated a variety of undiversified investment strategies for individual investors. The Motley Fool ([www.fool.com](http://www.fool.com)), for example, advo-

reduce the systematic risk of a portfolio of shares increases shareholder welfare.<sup>55</sup> Negative forces in the economy may impact a number of companies in a similar manner, causing the market, for example, to overvalue such companies. Firm-specific information from several companies in combination may then be useful to determine the extent of systematic overvaluation. For example, analysts may get a better sense of the overall direction of the economy through the assessment of revenue growth of a number of different companies.<sup>56</sup> Furthermore, accurate share prices allow a corporation to use less of its own stock in employee compensation plans as well as to acquire other companies,<sup>57</sup> thus benefiting the traded firm's shareholders. From the perspective of non-shareholder third parties, greater share price accuracy may also provide positive external benefits. For example, a company conducting an initial public offering may rely on the share price of a competing already-public company to set the offering price. More generally, greater price accuracy will lead to more efficient capital allocation with positive benefits throughout the economy.<sup>58</sup>

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cated among other strategies a "Foolish Four" strategy under which an investor mechanically "selects four stocks from the 30 companies that comprise the Dow Jones Industrial Average. The stocks are selected based on low price and high dividend yield." See The Motley Fool, *Foolish Four Portfolios*, available at <http://www.fool.com/portfolios/discontinued/fool4.htm> (last visited Nov. 17, 2002) (providing a description of the now discontinued Foolish Four strategy).

55. Diversification, of course, negates the cost of unsystematic stock price inaccuracies. Consider an investor who holds an index fund containing a value-weighted share of all stocks in the market. Across the range of stocks, some will be overvalued and some undervalued. Where stocks are on average correctly valued, nevertheless, the investor holding a diversified portfolio will not suffer any increased risk due to the presence of price inaccuracies. The overvalued and undervalued stocks will tend to cancel out within the portfolio.

56. In contrast, Marcel Kahan argues that firm-specific information will not reduce systematic volatility in the market to the extent such volatility is due to "liquidity crunches, overreaction to information, or market-wide speculative trading." Marcel Kahan, *Securities Laws and the Social Costs of "Inaccurate" Stock Prices*, 41 DUKE L.J. 977, 1003 (1992).

57. To the extent employees are risk-averse (particularly for undiversified holdings of their own company's stock), they will demand a higher level of compensation for more inaccurate (and thus high variance) stock, all other things being equal.

58. Kahan makes the argument that accurate securities prices are important for efficient capital allocation. See Kahan, *supra* note 56, at 1005-17. To the extent more efficient capital allocation increases the value of corporations as a group, investors holding diversified portfolios benefit. Such investors will therefore internalize the benefit from more efficient capital allocation across different portfolio companies. See, e.g., Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation*, 107 YALE L.J. 2359, 2368 (1998) ("The majority of investors hold portfolios, not single shares of stock, and therefore, unlike the issuer, they will internalize the externality if they make the disclosure decision."). Other third parties may benefit from more accurate securities prices. When the stock market enters into a speculative bubble, rising stock valuations may make consumers feel wealthier leading to increased consumer spending in the economy. On the other hand, when a stock market bubble bursts, consumers may suddenly feel poorer, leading to a dramatic drop-off in spending and possibly a recession affecting the entire economy. See Kahan, *supra* note 56, at 1034-35. Merritt Fox has argued that accurate securities prices —



Where the information derived from informed trades eventually would have reached the market in any case, the benefit in stock price accuracy is simply one of timing.<sup>59</sup> For example, when an insider trades based on nonpublic material information about the insider's own company, the stock market price may adjust to take into account what that trade reveals about stock price accuracy. To the extent the traded firm plans to disclose such information in its next quarterly SEC filing, the benefit to stock market accuracy comes only from the acceleration of disclosure in time from the date the insider engages in trades to the date of the quarterly SEC filing.<sup>60</sup> Timing, nevertheless, is important in the securities markets. For employees taking compensation in stock or an acquisition target's shareholders receiving stock as consideration, the valuation of the stock at the time they receive the stock is of paramount importance. Information that arrives only after they take the stock does not lower the risk they face from stock price inaccuracy at the time they receive the stock. Similarly, a company contemplating a securities offering must make a decision at the start date of the offering as to how to price the offering. The pricing decision, in turn, may depend on the securities prices of related companies in the same industry. Information that arrives only after the pricing decision does not benefit the company conducting the securities offering.<sup>61</sup>

The presence of informed trades may also impact other market participants negatively. For example, investors seeking an information advantage may take actions that impose costs on other investors which increase the magnitude of the information advantage. Insiders of the traded firm may choose to delay disclosure of confidential projects within the traded firm to enhance their ability to engage in insider trading.<sup>62</sup> Insiders may also choose to shift the projects within the

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by assisting the movement of resources to their highest value use — benefit other factors of production including labor, for example. See Merritt B. Fox, *Securities Disclosure in a Globalizing Market: Who Should Regulate Whom*, 95 MICH. L. REV. 2498, 2562-69 (1997).

59. See Kahan, *supra* note 56, at 999-1001 (discussing the impact of timing on the value of accurate securities prices).

60. For Form 10-Q, see Forms, Securities Exchange Act of 1934, 17 C.F.R. § 249.308a (2002).

61. Companies conducting an initial public offering may care about their ability to accurately price their offering for a number of reasons. For firm commitment offerings, the underwriter promises to purchase a company's securities for resale to the public. To the extent the pricing of the offering is uncertain, the underwriter may choose to sell the securities at a lower price to the market to avoid the risk of not selling out the entire offering. Alternatively, the underwriter may demand a higher commission to compensate for the increased risk of mispricing the market.

62. See Robert J. Haft, *The Effect of Insider Trading Rules on the Internal Efficiency of the Large Corporation*, 80 MICH. L. REV. 1051, 1051-64 (1982); Saul Levmore, *Securities and Secrets: Insider Trading and the Law of Contracts*, 68 VA. L. REV. 117, 149 (1982) (arguing that insiders may structure a corporation's transactions to profit from insider trading); Kenneth Scott, *Insider Trading: Rule 10b-5, Disclosure, and Corporate Privacy*, 9 J. LEGAL

traded firm to lower overall value but focus on more confidential projects in an effort to increase their insider trading profits.<sup>63</sup> Outsider traders may also engage in acts that impose costs on other market participants to increase their trading advantage. An employee of one firm, for example, might intentionally reduce the value of her firm in order to create a profitable trading opportunity in the stock of the firm's rivals.<sup>64</sup> Or an outsider trader with information that a particular company is overvalued might attempt to disseminate misinformation to the market that the company is in fact undervalued to increase her trading advantage.<sup>65</sup> To the extent other investors believe the misinformation, the amount the informed investor benefits at the expense of the uninformed investor increases and stock price accuracy is reduced. Outsider traders who misappropriate their information from a source that otherwise would have used the information to engage in securities transactions impose a trading cost on the source. The source may also lose to the extent the use of misappropriated information results in the dissemination of information that the source would have otherwise kept confidential. Other market participants may then bear a cost to the extent the source chooses not to generate the information in the first place. The possibility that informed trading will impose costs on a traded firm's uninformed shareholders may also induce the traded firm to disclose information (say about its most recent sales) sooner than would be optimal but for the desire to preempt the monetary transfer worked by informed trading.<sup>66</sup> The presence of informa-

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STUD. 801, 810-11 (1980). *But see* James D. Cox, *Insider Trading and Contracting: A Critical Response to the "Chicago School,"* 1986 DUKE L.J. 628, 635-36 (noting that little empirical evidence exists demonstrating the existence of abusive practices designed to increase the value of insider trading).

63. Alternatively, managers may engage in more risky projects designed to create large swings in firm value of which managers with inside information may take advantage through trades in the firm's securities. *See, e.g.,* Easterbrook, *supra* note 22, at 332.

64. *See* Ayres & Bankman, *supra* note 9, at 281 n.141 (discussing the possibility of an "Atlas Shrugged" scenario in which a firm profits by first secretly destroying the value of its own productive assets and then second reaping trading profits on related firms based on news of the destruction).

65. The SEC has paid particular attention to so-called "pump and dump" schemes under which an investor first purchases a large quantity of a company's securities, portrays the company as favorable, and then sells the securities as the price increases. *See* Jerry Markon, *U.S. Says Brokers Bilked Customers Of Over \$50 Million*, WALL ST. J., Mar. 9, 2001, at A4 (announcing indictments for stock fraud against, among others, members of the Gambino crime family for a "pump and dump" scheme); *see also* Market Manipulation, *Particularly Online, Is Way Up, SEC Says*, WALL ST. J., Nov. 7, 2000, available at 2000 WL-WSJ 26615864 (reporting that "[p]reliminary figures show that market manipulation accounted for 8% of the roughly 500 cases the SEC brought in fiscal 2000, ended Sept. 30, up from 3% in fiscal 1999").

66. Indeed, the present mandatory disclosure system can be viewed as reducing the informational advantage insiders of the firm may enjoy over outsider traders. For a discussion of the corporate governance implications of mandatory disclosure, *see* Fox, *Required Disclosure*, *supra* note 53. NASDAQ also imposes a requirement that listed companies must

HeinOnline -- 101 Mich. L. Rev. 334 2002-2003

tional disparities in the market may also put market makers<sup>67</sup> at risk, raising the bid-ask spread the market makers demand for the liquidity service they provide to the market.<sup>68</sup>

The decision to engage in information research leading to an increase in informed trades in the securities markets therefore encompasses a number of disparate effects on various market participants. For many forms of informational disparities, no one party takes into account all such effects from their information-related decisions. As discussed above, an informed trader generally ignores the loss to uninformed traders from its decision to engage in information research. The informed trader compares a private benefit (the transfer of trading profits) to the private (and social) cost of research, but ignores a host of external social costs and benefits that are likely to determine whether the informed trading is on balance socially productive. As a theoretical matter, therefore, a laissez faire regime may produce too little or too much informed trading. Absent Coasean bargaining, we may observe too little informed trading to the extent that the social benefits (in enhanced stock pricing and the like) exceed the private benefit of trading profits. Additionally, absent Coasean bargaining we may observe too much informed trading to the extent that the social costs of such trading exceed social benefit.<sup>69</sup> Nevertheless, certain

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"[e]xcept in unusual circumstances . . . make prompt disclosure to the public through the news media of any material information that would reasonably be expected to affect the value of its securities or influence investors' decisions . . ." NASD Manual (CCH), Rule 4310(c)(16).

67. The SEC defines a "market maker" as "a firm that stands ready to buy and sell a particular stock on a regular and continuous basis at a publicly quoted price." SEC, *Market Maker*, at <http://www.sec.gov/answers/mktmaker.htm> (last visited Oct. 11, 2002).

68. See Kahan, *supra* note 56, at 1017-22. Kahan makes the argument that stock price inaccuracies may lead more unsophisticated investors to fear that they are at a disadvantage with respect to the rest of the market. Such unsophisticated investors will then eschew trades, reducing the liquidity in the stock. Lower liquidity, in turn, raises the transaction costs to all investors seeking to engage in trades. See *id.* In situations where a market maker provides liquidity, the absence of unsophisticated investors will expose the market maker to higher risks, raising the bid-ask spread the market maker charges for its liquidity service.

Gideon Parchomovsky pointed out to us that from a Coasean perspective the uninformed traders cause an increase in the bid-ask spread just as much as the informed traders. This reasoning is impeccably true — just as the pedestrian victim causes her fatality by walking through a crosswalk at the same time as a drunk driver. But in both cases, efficiency and equity concerns militate toward putting liability on the least cost avoider who to our minds is not the victim.

69. Lynn Stout, in particular, has put forth the argument that investor research (and other costs associated with stock trading including commission fees) may result in socially wasteful expenditures as investors engage in speculative trades. See Lynn A. Stout, *Are Stock Markets Costly Casinos? Disagreement, Market Failure, and Securities Regulation*, 81 VA. L. REV. 611 (1995). Other commentators have questioned the social value of speculative trading. See Joseph E. Stiglitz, *Using Tax Policy to Curb Speculative Short-Term Trading*, 3 J. FIN. SERVICES RES. 101, 103 (1989); Lawrence H. Summers & Victoria P. Summers, *When Financial Markets Work Too Well: A Cautious Case for a Securities Transactions Tax*, 3 J. FIN. SERVICES RES. 261, 271-72 (1989).

types of information-related decisions involve parties who internalize more market-related effects than others. The next two sections distinguish trades based on information internal to the traded firm and trades based on outsider information advantages. Somewhat surprisingly, we find that insider trading (to which the traded firm consents) is presumptively more efficient than outsider trading (that proceeds without needing to garner the traded firm's consent).

### B. *Implications for Insider Trading*

Information internal to the traded firm (termed "inside information") will often provide investors with a significant advantage in determining the valuation of the traded firm. The traded firm, for example, may have plans to undertake a major business expansion into new foreign markets. Alternatively, the traded firm may plan to engage in large cutbacks in its operations, reducing both the size of its staff and

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In Stout's view, investors often come to disparate conclusions on the value of a particular security through their efforts at research. See Stout, *supra*, at 625-35. Given a range of investors with heterogeneous expectations, investors with higher expectations will seek to purchase securities from investors with lower expectations. See *id.* at 627-28. Investors trading in such an environment will just as likely be on the winning side of a transaction as on the losing side. Once the costs of engaging in information research and other transaction costs associated with trading are taken into account, investors who trade on average lose money relative to those investors who take a simple buy-and-hold strategy. See *id.*; see also *id.* at 636-41 (noting that investors more optimistic about their investment prowess self select themselves into the group of actively trading investors). Stout, moreover, argues that the liquidity benefits from speculative trading are outweighed by the large costs associated with such trades. See *id.* at 683-88. Stout also contends that speculative trading driven by heterogeneous expectations are unlikely to increase share price accuracy. To the extent speculative traders generate heterogeneous expectations, Stout argues that "investor disagreement and varying degrees of ignorance will ensure that stock prices bear only the roughest correspondence to their intrinsic values." *Id.* at 690. Stout notes also that "adding large numbers of speculating [heterogeneous expectation] traders to a market where investors already trade modest amounts of stock for liquidity or portfolio-balancing reasons actually may decrease the already questionable level of fundamental efficiency found in the market." *Id.* at 690-91 (emphasis omitted).

Our model differs from Stout's conception of securities trading in one important respect: we do not assume that information research leads investors to reach heterogeneous expectations that on average do not increase overall share price accuracy. While research may result in only a noisy signal of the true value of a security, we assume nevertheless that this noisy signal is still informative. Thus, investors who engage in informed research are privately (and systematically) able to do better through securities trades compared with uninformed investors. Moreover, under our model informed trades are assumed to unambiguously increase the accuracy of stock prices (although the magnitude may be small for information that would have been disclosed soon to the market regardless of the securities trades). Of course, once multiple investors start to compete through investment research, trading profits may become competed away. Nevertheless, the positive impact of stock price accuracy does not allow us to conclude, as Lynn Stout does, that "federal securities policy . . . should seek to minimize the incidence and costs of speculative trading." *Id.* at 712. Instead, as we argue, the net costs and benefits of informed securities trading are ambiguous and we therefore propose later in the Article that the traded firm should have the ability to determine the extent of allowable informed trading in its own securities rather than pursue a one-size fits all approach to speculative trading.

product line. Knowledge of such information affords investors a greater ability to assess the value of the traded firm.

Given the large advantage inside information may provide certain investors, regulators have focused much of their attention on the use of such information. Under the U.S. securities laws, Rule 10b-5 of the Exchange Act forms the core of the insider trading prohibition.<sup>70</sup> Insiders of the traded firm, among others, may not trade based on non-public material information relating to the traded firm.<sup>71</sup> Rule 10b-5 also extends to the trading use of tips that insiders may provide to outside tippees in a situation where the insider-tipper breaches her fiduciary duty and the tippee has reason to know of the breach.<sup>72</sup>

This Article's framework, nevertheless, provides support for Henry Manne's contention that corporations already internalize many

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70. See § 10b of the Securities Exchange Act of 1934, § 15 U.S.C. 78j (2000); 17 C.F.R. § 240.10b-5 (2001) (Rule 10b-5). During the 1980s, Congress passed both the Insider Trading Sanctions Act ("ITSA") and the Insider Trading Securities Fraud Enforcement Act ("ITSFEA"), both designed to increase penalties for insider trading. In addition, the ITSFEA expanded the scope of "controlling person" liability. See generally Jesse M. Fried, *Reducing the Profitability of Corporate Insider Trading Through Pretrading Disclosure*, 71 S. CAL. L. REV. 303, 309-10 (1998) (describing the ITSA and the ITSFEA).

In addition to Section 10(b) and Rule 10b-5 of the Exchange Act, other barriers to insider trading on the part of corporate insiders exist. For example, under Section 16(b) of the Securities Exchange Act of 1934 corporate officers, directors, and shareholders who beneficially own greater than ten percent of any class of the corporation's equity must give back to the corporation profits they earn on any purchase then sale or sale then purchase combination of transactions that occur within any period of less than six months. See Section 16(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78p(b) (2000); see also Section 16(c) of the Securities Exchange Act of 1934, 15 U.S.C. § 78p(c) (2000) (prohibiting insiders from engaging in short sales of their own company stock). Corporate law prohibitions also exist against insider trading. See WILLIAM K.S. WANG & MARC L. STEINBERG, *INSIDER TRADING* 1105-172 (1996) (addressing the state law on insider trading); Donald C. Langevoort, *Insider Trading and the Fiduciary Principle: A Post-Chiarella Restatement*, 70 CAL. L. REV. 1, 2 n.5 (1982) (citing state law cases dealing with insider trading).

71. See, e.g., *United States v. Chiarella*, 445 U.S. 222, 232-33 (1980) (requiring a duty to disclose before imposing Rule 10b-5 insider trading liability); see also *In re Cady, Roberts & Co.*, 40 S.E.C. 907, 911 (1961) (presenting the SEC's position that "[w]e, and the courts have consistently held that insiders must disclose material facts which are known to them by virtue of their position but which are not known to persons with whom they deal and which, if known, would affect their investment judgment. Failure to make disclosure in these circumstances constitutes a violation of the anti-fraud provisions. If, on the other hand, disclosure prior to effecting a purchase or sale would be improper or unrealistic under the circumstances, we believe the alternative is to forego the transaction . . .").

72. See, e.g., *SEC v. Dirks*, 463 U.S. 646 (1983). Again basing insider trading liability under Rule 10b-5 on the breach of a fiduciary duty, Justice Powell held that a tippee is liable for trading in confidential inside information only to the extent the corporate insider tipper "breached his fiduciary duty to the shareholders by disclosing the information to the tippee and the tippee knows or should know that there has been a breach." *Id.* at 660. Justice Powell further elaborated on what constituted a fiduciary breach on the part of a tipper writing that a breach occurs when "the insider personally will benefit, directly or indirectly, from his disclosure. Absent some personal gain, there has been no breach of duty to stockholders. And absent a breach by the insider, there is no derivative breach." *Id.* at 662. In dictum, Justice Powell also noted that agents in a special confidential relationship with the corporation may be treated as "temporary insiders" for insider trading purposes. See *id.* at 655 n.14.

of the costs and benefits from trades based on inside information on the part of its managers.<sup>73</sup> Consider the following example involving Texon, a publicly-traded manufacturer of Texas tangy barbeque sauce. Assume that Texon has plans to enter into new foreign markets. Using our framework, first note that traders with an inside information advantage will enjoy a trading profit from the use of such information. Assume that the information on Texon's foreign expansion plans, if known, would result in a share price increase for Texon of \$10. Moreover, assume that an informed investor with such information would have the ability to trade 10,000 shares before the market price adjusted upward by the full \$10. For simplicity, assume that the inside information will provide an investor with an expected gross trading advantage of \$100,000.<sup>74</sup>

Second, note from the Article's framework that traders who seek to obtain an inside information advantage may need to expend resources in obtaining such information. Although a manager might casually acquire a good deal of material nonpublic information merely as a by-product of carrying out her independently compensated duties, a manager that desires to obtain an insider information advantage may need to expend added effort in sorting through and identifying the valuable internal information within the company. In the Texon example, assume that managers that seek to engage in insider trading expend the equivalent of \$2,000 of their own time and resources in making such trades. So the net expected benefit to managers from engaging in insider trading in the Texon example is \$98,000.

Managers of Texon seem, therefore, to benefit at the expense of uninformed investors. The contractual relationship between managers and their employer, however, allows the traded firm to internalize these effects in deciding whether to permit or prohibit managerial trading. Because the managers are in privity with Texon, Texon will internalize the net benefit to the managers from engaging in insider trading. Managers, for example, that expect to receive a benefit of \$98,000 from their employment due to insider trading will be willing to work at the traded firm for a correspondingly reduced salary.<sup>75</sup> Texon,

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73. See MANNE, *supra* note 27.

74. As Ayres and Bankman note, the potential profits of managers having laissez faire insider trading rights might under more plausible assumptions easily run into the tens of millions of dollars. See Ayres & Bankman, *supra* note 9, at 270. To adequately compensate a firm for being given such a trading right, the manager would not only need to reduce her salary but in most instances would have to make a net payment to the corporation of several million dollars per year. The textual assumption of \$100,000 profit is more plausible under an employment contract that merely grants the manager a limited right to trade the stock of its own firm. See *id.*

75. See MANNE, *supra* note 27, at 138-41. Manne makes the argument, moreover, that compensation through insider trading may provide managers with more effective incentives than through stock options or restricted stock. When a manager is compensated through stock options or restricted stock, the upside potential of such compensation is limited by the

in making its decision on how much to provide its managers in direct compensation, will therefore have the ability to attract the same quality executives with \$98,000 reduced compensation compared with rivals that prohibit insider trading, all other things being equal.<sup>76</sup> Of course, risk-averse managers may not view an expected \$98,000 from insider trading profits the same as a certain \$98,000 cash compensation. Therefore, Texon may not be able to reduce the cash compensation to risk-averse managers by the full \$98,000. On the other hand, giving managers the option to buy firm shares on the basis of nonpublic information may provide managers with better incentives to maximize firm value. To the extent that managers increase firm value more than the market expects, managers may then take advantage of this increase through purchases of undervalued securities in the market. Certainly, managers may also have an incentive to decrease firm value more than the market expects to assist the managers' short sales of the traded firm's shares. But the contractual relationship between managers and the traded firm allows the company to impose restrictions on the type of insider trading that are permitted. Most obviously, the traded firm may prohibit short sales on the part of managers of the firm's own securities so as to maintain appropriate managerial incentives.<sup>77</sup>

The traded firm will then take into account many of the impacts on other market participants from informed insider trading. Consider the third informational effect within the Article's framework: uninformed shareholders of the traded firm will suffer a harm equal to the corresponding trading benefit to managers from insider trading. In the example, note that the \$100,000 trading profit to insiders comes at the expense of uninformed Texon shareholders. This loss occurs regardless of whether managers use their information advantage to purchase

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number of options or shares granted to the manager. Thus, where the manager's marginal contribution to firm value exceeds the increase on the fixed number of options or shares in the hands of a manager, the manager will lack full incentives to maximize firm value. Insider trading, in contrast, allows a manager to profit more fully from her contribution to firm value. *See id.*

76. For an argument that the possibility of insider trading does not provide an efficient form of compensation, see STEPHEN M. BAINBRIDGE, *SECURITIES LAW-INSIDER TRADING* 136-39 (1999).

77. Such restriction would be similar to the restrictions currently imposed by some firms limiting managers' ability to sell or hedge employee stock option plans. *See* David M. Schizer, *Executives and Hedging: The Fragile Legal Foundation of Incentive Compatibility*, 100 COLUM. L. REV. 440, 460-61 (2000) (noting that while some firms employ limits on the ability of managers to hedge granted options through "trading policies" most firms do not). *But see* Stewart J. Schwab & Randall S. Thomas, *What Do CEOs Bargain For? An Empirical Study of Key Legal Components of CEO Contracts* (unpublished draft, Oct. 31, 2000) (on file with authors) (reporting that none of the 62 out of 93 sampled CEO compensation contracts restricted hedging transactions); *see also* Section 16(c) of the Securities Exchange Act of 1934, 15 U.S.C. § 78p(c); 17 C.F.R. § 240.16c (2001) (Rule 16c prohibiting insider short sales at Exchange Act reporting firms).

from uninformed Texon shareholders or sell Texon shares to non-Texon shareholders.<sup>78</sup> Where Texon openly allows for insider trading that reduces shareholder value, therefore, investors will demand a discount when Texon initially sells its shares to the public. Texon therefore internalizes the harm to investors in the market from its adopted insider trading policies.<sup>79</sup>

Finally, Texon will internalize many of the other impacts to market participants resulting from insider trading. The use of inside information in trades, for example, may result in greater share price accuracy.<sup>80</sup> Part of the benefit from more accurate securities prices will accrue directly to investors of Texon. As discussed above, more accurate securities prices will reduce the risk facing undiversified investors; even for diversified investors, more accurate securities prices may reduce the systematic risks of their portfolios.<sup>81</sup> The traded firm benefits directly to the extent that more accurate securities prices also allow the companies to provide a reduced level of stock compensation to employees or to use fewer securities in acquisitions.

Texon will also internalize the incentive of managers to adjust firm decisions to increase their ability to engage in insider trading. Managers, for example, may choose to delay the disclosure of information from Texon to the market as a whole or shift Texon's business projects toward lower value but more confidential projects.<sup>82</sup> To the extent such activities impose an increased expected cost to Texon's investors, the investors will demand a greater discount at the time they purchase their shares. At the time Texon initially offers its securities for sale,

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78. Suppose that Texon's securities are undervalued and managers therefore seek to purchase the securities from uninformed investors. Where managers purchase undervalued Texon securities, Texon shareholders who sell are directly harmed. Now suppose that Texon's securities are overvalued and that insiders seek to sell the securities to uninformed investors. Where rational non-Texon securities holders are unable to distinguish among selling parties, they will require this discount from all potential selling parties including uninformed Texon shareholders. For example, if informed traders account for 10% of the securities sale orders and tend on average (when they sell) to have information that shares are overvalued by \$10 per share, then the non-Texon securities holders will require a \$1 discount for all the shares they purchase. Suppose that the trade volume is 100,000 shares over some period of time. The informed traders (selling only when the shares are overvalued) will gain a net of \$90,000 (equal to \$9 per share advantage after discount times 10,000 shares); uninformed Texon shareholders seeking to sell shares (trading both when shares are overvalued and undervalued) on the other hand will lose by \$90,000 (equal to \$1 discount times 90,000 shares). Even where managers are selling to non-Texon shareholders, therefore, uninformed Texon shareholders bear the cost.

79. See, e.g., Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 305-07 (1976).

80. For an argument against the price accuracy benefit from insider trading, see BAINBRIDGE, *supra* note 76, at 128-36.

81. See text accompanying notes 55-56.

82. See *supra* note 62 (detailing possible abuses on the part of managers seeking to increase the profit potential from insider trading).



Texon will then internalize the negative consequences of its managers' actions to increase the value of insider trading.

The large degree of internalization on the part of the traded firm for insider trading calls into question the present regulatory focus within the securities laws on insider trading. At least two objections nevertheless are possible against allowing the traded firm to determine its own insider trading policy. First, the traded firm may ignore external positive effects on market participants from more accurate securities prices. Second, managers may abuse the ability to fashion an insider trading policy for their own personal self-interest at the expense of shareholders.<sup>83</sup> We address each in the context of our proposal to internalize outsider trading.<sup>84</sup>

But the gravamen of this Article is not to demonstrate that we must repeal the current mandatory provisions against insider trading. Rather we hope to make a different point. Despite the possible lack of complete internalization, *insider traders (who trade with the consent of the traded firm) internalize far more of the social consequences of informed trading than outsider traders (who trade without the traded firm's consent)*. Regardless of where one stands on the regulation of insider trading, an even greater argument exists that regulators should focus their attention on outsider trading involving informational disparities.

### C. Implications for Outsider Trading

No company operates in a vacuum. Because of the range of interactions with different economic actors that may affect a company's business, a number of sources of information outside the traded firm may prove significant in valuing the traded firm's securities. Companies interact regularly with customers, suppliers, regulators, and competitors. Economic forces outside the scope of an individual company's control, as well, may affect the company's business. A cutback in oil production from the Middle East will likely raise energy costs for a company, reducing net profits. Nonpublic information varying from a customer's plans for future orders to a regulator's intentions

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83. Responses are possible to managerial abuse of a corporate-determined insider trading policy regime. Under a self-dealing fiduciary duty standard, grants of trading rights that failed to limit the ability of managers to sell short should be strictly scrutinized. See Ayres & Bankman, *supra* note 9, at 270-75 (discussing self-dealing standard). And it might be advisable to force managers to price the value of the managerial insider trading option both ex ante (as part of the executive compensation disclosure contained in the corporate proxy statement) and ex post (as part of the disclosure of actual insider trades under Section 16(a) of the Exchange Act) to help shareholders evaluate whether the firm was adequately compensated for granting this right. See Ayres & Bankman, *supra* note 9, at 278. For a more detailed discussion of the possibility of managerial opportunism under a private outsider trading regime, see *infra* Section IV.A.2.

84. See *infra* Section IV.A.

toward imposing costly environmental production controls will affect the traded firm's stock market price once such information becomes public.

Outside information pertinent to the valuation of the traded firm, in turn, may be separated into two categories: information that would have been created without regard to trading profit (termed "non-trading information") and information obtained with a specific view to generating trading profits (termed "trading information").<sup>85</sup> Outside parties will often generate non-trading information without regard to the benefits obtainable from the use of such information in securities market transactions. For example, a supplier may make the decision that it will increase the price for its goods sold to the traded firm over the next year. Information on the decision to raise prices is generated regardless of the potential trading profits possible with this information. Similarly, regulators may make a decision that impacts firm value. The U.S. Federal Reserve Open Market Committee ("FOMC"), for example, may make a decision to lower interest rates.<sup>86</sup> Information on the rate cut will be generated by the FOMC regardless of possible trading profits.

Trading information, in contrast, relates to information deliberately acquired to engage in profitable securities market trades. Trading information first encompasses information obtained derivatively from sources that develop non-trading information. An analyst for example, may expend resources in calling various suppliers to determine their upcoming inventory needs and pricing policies. An investor may telephone a member of the FOMC to learn about impending interest rate changes. To the extent obtained with the goal of generating trading profits, the non-trading information in the hands of the suppliers becomes trading information in the hands of the analyst or investor. Trading information also encompasses new information that investors may generate through skillful analysis of myriad pieces of data. For example, a securities analyst may combine information on car production in Europe with trends in energy prices to assess the value of those auto manufacturers inside the United States. To the extent the new assessment constitutes information that would not have been created without the opportunity to engage in profitable securities market trades, the information is trading information. Regulations aimed at the use of information to engage in securities market transactions, in turn, will have an effect only on the production of trading in-

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85. This distinction between "trading" and "non-trading" information parallels the distinction that Anthony Kronman made long ago regarding "deliberately" and "casually" acquired information. See Kronman, *supra* note 12.

86. Information on the U.S. Federal Reserve Open Market Committee and its role in establishing interest rates may be found at <http://www.federalreserve.gov/fomc/> (last visited July 14, 2001).

formation. Outside parties will continue to produce non-trading information regardless of limits placed on informed trades.<sup>87</sup>

To gauge the necessity of regulating the production of trading information, let us apply again the four-part information framework. Our basic contention is that insider trading that proceeds only with the consent of the traded firm is more likely to promote social welfare than outsider trading that can proceed irrespective of the traded firm's consent. A contract between the trader and the traded firm would internalize much more (and to our minds virtually all) of the social costs and benefits of informed trading and hence is much more likely to permit socially valuable informed trading to occur. As a theoretical matter, outsider trading without the consent of the traded firm can increase or decrease social welfare. But as an empirical matter, we believe that external costs are likely to be more prevalent than external benefits so that in equilibrium we are likely to see too much informed trading as a result of the current law's failure to force outsider traders to garner the consent of the traded firm.<sup>88</sup>

To see this relative failure of internalization, return to the Texon hypothetical and assume that Helen, an outsider trader, is considering expending resources to obtain trading information relevant to the valuation of Texon. Helen, as with all potential informed traders, will internalize her direct cost of obtaining the trading information as well as the trading benefits from the use of such information in the securities markets. Suppose that the cost of obtaining trading information on Texon to Helen equals \$40. Moreover, assume that the trading benefit Helen can obtain is expected to equal \$100. With nothing more, Helen will choose to expend costly effort to obtain the information advantage with respect to Texon. From such information research, Helen obtains an expected trading profit of \$60.

Helen, nevertheless, ignores the impact of her information research on other market participants. Uninformed investors as a group will lose \$100 on an expected basis from Helen's information advantage. On the other hand, the stock market price accuracy of Texon's securities may increase from Helen's informed trades. The value of the increase in accuracy depends in turn on whether Helen's information would have made its way into the public capital markets without Helen's efforts and at what time in the future.<sup>89</sup> Assume that Texon's

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87. See Ayres & Bankman, *supra* note 9, at 288 (noting that parties will continue to learn of casually acquired information regardless of disclosure requirements).

88. The possibility of excessive informed trading is particularly true for large traded firms with extensive followings of investment analysts and other sophisticated investors. For smaller traded firms with a smaller analyst base (if any), the balance between the external costs and benefits may swing toward too little informed trading in equilibrium.

89. For a discussion of the timing aspects of securities price accuracy, see *supra* notes 59-61 and accompanying text.

shareholders gain \$10 from the increase in accuracy and the non-shareholder third parties gain an additional \$2. Taking into account the effects upon other investors, therefore, Helen's decision to expend resources to obtain the information advantage creates a net loss of \$28. While Helen privately benefits, information trading harms overall social welfare.

In the extreme where information research provides no benefit to market participants other than the informed trader, engaging in information research always results in a net social loss. This result tracks the insight of Jack Hirshleifer. Hirshleifer presents a model in which information research that simply accelerates the timing of when information is uncovered (termed "foreknowledge") in a pure exchange economy generates no new value to the market as a whole.<sup>90</sup> Where information research is costly and all market participants would inevitably have access to the same information, informed traders ignoring the loss to other parties from their trades will engage in excessive research from a social perspective.

The possibility of competition among investors to obtain an information advantage may then generate even greater amounts of overinvestment in securities research. Investors may generate duplicative research expenditures and compete away the profits from information research. Because multiple informed investors reduce the profit available to any one informed investor, investors may then have an incentive to race to become the first investor with an information advantage.<sup>91</sup> In the context of the debate over mandatory disclosure, Jack Coffee in part relies on the argument that analysts may otherwise duplicate (and thus waste) information research without mandatory dis-

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90. See Jack Hirshleifer, *The Private and Social Value of Information and Reward to Inventive Activity*, 61 AM. ECON. REV. 561, 562-66 (1971). In Hirshleifer's model, participants start with a fixed endowment of present goods as well as an endowment of goods for two possible states in the future, states A and B. With some known probability state A will in fact be realized; likewise, with some known probability state B will be realized. In equilibrium, multiple participants trading among themselves in the present will then generate prices for the present good as well as for contingent goods in states A and B. The more likely state A, the higher the price for goods in state A in equilibrium. Hirshleifer then introduces an informed trader that knows for certain whether state A or B will in fact occur in the future. With nonpublic knowledge that state A will occur, for example, the informed trader may sell her B endowment and purchase as much of the state A good as possible. To the extent the information in the hands of the informed trader only changes the timing of when parties learn about whether state A or B occurs and not the total endowment of goods A or B, informed trades result in only a zero-sum transfer of wealth from uninformed to informed traders. See *id.*

91. The race to obtain an information advantage in the securities markets is analogous to patent races. For a discussion of the economics of patent races, see Jennifer F. Reinganum, *The Timing of Innovation: Research, Development, and Diffusion*, in 1 HANDBOOK OF INDUSTRIAL ORGANIZATION 849 (Richard Schmalensee & Robert D. Willig eds., 1989). See also Gideon Parchomovsky, *Publish or Perish*, 98 MICH. L. REV. 926 (2000) (arguing that competitors in a patent race may choose to focus on preventing others from "winning" rather than winning the race themselves).

closure from the traded firm.<sup>92</sup> However, not all information relevant to the valuation of a traded firm derives from within the traded firm. Mandatory disclosure, therefore, does not present an easy solution for the duplicative research problem with respect to outside information. Moreover, the present mandatory disclosure regime does not force the disclosure of all material information, leaving firms the ability to keep substantial parts of their internal information confidential.

Critics may nevertheless respond that the amount of duplicated information research in the markets is self-limiting. Sanford Grossman and Joseph Stiglitz provide the insight that the level of market information efficiency is in equilibrium with the amount investors spend on information research costs.<sup>93</sup> Some degree of informational inefficiency in market prices is required to give investors an incentive to engage in research. On the other hand, investors individually will only expend resources up to the point where they earn zero economic profits from their ability to profit in market trades from the research. In equilibrium, investors should earn competitive market returns after taking into account their information research costs.<sup>94</sup>

The mere fact, however, that investor information research is self-limiting does not guarantee that social welfare is at a maximum under the laissez-faire approach to outsider trader information research. The tragedy of the commons is self-limiting in the sense that individuals ignoring the collective good will only have the ability to bring the value of the commons to zero, but not below zero.<sup>95</sup> Likewise, companies seeking monopoly rents will expend resources attempting to obtain a monopoly. The expenditures to obtain a monopoly are also self-limiting in the sense that companies engaging in such rent-seeking will, in a competitive equilibrium, expend resources up to the amount of their expected benefit from the monopoly, leaving the companies with a competitive return.<sup>96</sup> Despite the competitive return, companies

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92. See John C. Coffee, Jr., *Market Failure and the Economic Case for a Mandatory Disclosure System*, 70 VA. L. REV. 717, 733 (1984). ("[A] major significance of a mandatory disclosure system is that it can reduce these [duplicated] costs. Rival firms do not need to incur expenses to produce essentially duplicative data banks when a central securities data bank is in effect created at the SEC.")

93. See Sanford J. Grossman & Joseph E. Stiglitz, *On the Impossibility of Informationally Efficient Markets*, 70 AM. ECON. REV. 393 (1980).

94. Empirical studies of mutual fund performance, for example, have found that the funds earn a risk-adjusted return just sufficient to cover their information research and management costs. See Richard A. Ippolito, *On Studies of Mutual Fund Performance*, 49 FIN. ANALYSTS J. 42 (1993).

95. For a description of the tragedy of the commons problem, see Garrett Hardin, *The Tragedy of the Commons*, 162 SCIENCE 1243 (1968).

96. See generally Richard A. Posner, *The Social Cost of Monopoly and Regulation*, 83 J. POL. ECON. 807 (1975) (arguing that rent-seeking competition among parties seeking to obtain monopoly profits results in the dissipation of such profits). In the context of insider trading regulation, Haddock and Macey have made the argument that a prohibition on in-

engaged in rent-seeking waste resources in doing so. Likewise, outsider traders, ignoring the cost of their trades to uninformed investors, may reduce overall social welfare in their desire to obtain a brief monopoly informational position that allows them to profit from securities trades.

The possibility of having to split trading profits with other outsiders or the failure of outside investors to internalize all the social benefits of informed trading could also as a theoretical matter result in too little information research. Individual investors making the decision whether to engage in information research will ignore any beneficial impact from this research on other market participants. As detailed in the Article's information framework, information research may increase the accuracy of the stock market price. To the extent the social benefit from increased stock market price accuracy exceeds the total amount spent on information research, investors may have too few incentives to engage in securities research.<sup>97</sup>

More generally, Jack Hirshleifer has shown that where information research may in fact affect resource allocation decisions (due to shifts in prices resulting from the research), trading profits resulting from the investments in information may create either excessive or insufficient incentives for the trader to produce the information.<sup>98</sup> Hirshleifer was analyzing the potential trading profits that might be garnered from a new invention (in the absence of patent law), but his analysis is equally applicable to the incentives to produce other types of socially valuable information.<sup>99</sup>

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sider trading may prove socially wasteful to the extent outside investment analysts compete with one another to acquire and use the firm-specific information upon which the insiders are prohibited from trading. See David D. Haddock & Jonathan R. Macey, *A Coasian Model of Insider Trading*, 80 NW. U. L. REV. 1449, 1463 (1987) (noting that "[a] ban also increases incentives for market professionals to invest in ways that speed the acquisition of firm-specific information. The latter investments constitute a waste of real resources because insiders obtain the same information in the course of their normal duties without having to expend resources searching for it, and they can transfer the information to the securities markets more promptly than do the professionals."). Similarities between the race to gain an information advantage in the securities markets and the race to obtain a patent exist. For a discussion of the patent race literature, see *supra* note 91.

97. Note that two of the effects from an information advantage — the trading profits to informed traders and the trading losses to uninformed traders — are zero-sum in total.

98. See Hirshleifer, *supra* note 90, at 572. On the other hand, Hirshleifer argued that where a difference in beliefs exists among individuals, the individuals expend excessive resources in disseminating their own private information to the public domain to profit from an induced change of price. See *id.* at 569.

99. See *id.* at 570-72 (noting that "[t]here is no logically necessary tie between the size of the technological benefit on the one hand, and the amplitude of the price shifts that create speculative opportunities on the other"); see also Robert G. Hansen & John R. Lott, Jr., *Profiting from Induced Changes in Competitors' Market Values: The Case of Entry and Entry Deterrence*, 43 J. INDUS. ECON. 261 (1995) (expanding on Hirshleifer's insight to show that economic actors may be motivated through speculative trading profits in the securities of a wide variety of related companies affected by the economic actors' decisions).

Despite the possibility that individual investors may choose to engage in either too much or too little securities research from a social welfare perspective, regulators have generally left the decision to engage in such research free of regulation. The next Part discusses the areas in which regulators within the United States in fact have focused on outsider trading, assessing the efficacy of such provisions given the Article's informational effects framework.

### III. THE PRESENT U.S. REGULATION OF OUTSIDER TRADING

Securities regulators within the United States have until relatively recently focused primarily on the trading advantage that insiders of companies may enjoy in the secondary market with respect to their own companies' securities. Referred to as "classical" insider trading doctrine, trading prohibitions placed on insiders are well developed within the securities laws.<sup>100</sup> Eschewing a general approach to all informational disparities, classical insider trading doctrine encompasses trading information derived from the traded firm that a specified set of investors, insiders, use to their advantage in the markets.

Despite the narrow focus of classical insider trading doctrine, the securities laws have since branched more generally to address the trades of outsider traders. Today, outsider traders face securities law prohibitions against transactions based on nonpublic material information in three primary areas:<sup>101</sup> (a) the misappropriation theory of insider trading; (b) Rule 14e-3 of the Exchange Act's ban on informed trades during a tender offer based on information obtained from either the target or acquiring company,<sup>102</sup> and (c) Regulation FD's limit on the ability of firms to disclose nonpublic, material information selectively.<sup>103</sup> This Part examines each doctrinal area and assesses the efficacy of the regulations from the perspective of social welfare.

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100. See Pritchard, *supra* note 13, at 18-19 (describing the "classical" theory of insider trading).

101. Securities laws prohibitions also exist against two specific forms of secondary market abuses involving outsider trading: frontrunning and scalping. Frontrunning occurs when a broker-dealer or investment advisor uses information on a client's upcoming transaction and trades ahead of the client. Scalping takes place when a broker-dealer or investment advisor first invests in a particular security and then second recommends the same security. After the security price rises as a result of the recommendation, the broker-dealer or investment advisor then sells the securities for a profit. See David M. Bovi, *Rule 10b-5 Liability for Front-Running: Adding a New Dimension to the "Money Game,"* 7 ST. THOMAS L. REV. 103, 103-04 (1994) (defining frontrunning and scalping and discussing legal prohibitions). Similarly, the federal mail and wire fraud statutes, 18 U.S.C. §§ 1341, 1343 (2000), may also apply to the misappropriation of intangible information. See RALPH C. FERRARA ET AL., *INSIDER TRADING AND THE WALL* § 2.03 (2000).

102. See Section 14(e) of the Securities Exchange Act of 1934, 15 U.S.C. § 78n(e) (2000); 17 C.F.R. § 240.14e-3 (2001).

103. Because the information obtained through a selective information disclosure derives from the traded firm, Regulation FD may be viewed as a part of the classical insider

### A. Misappropriation Theory

From the perspective of capital market liquidity and investor welfare, all forms of informational disparities have common effects on the risks uninformed investors face as well as the efficiency of the market price. Although the present securities laws lack a general provision dealing with informational disparities, one doctrine comes close: the misappropriation theory of insider trading.<sup>104</sup> Unlike classical insider trading theory, the misappropriation theory focuses on all possible sources of information giving traders an advantage over uninformed investors. The misappropriation theory makes it unlawful for anyone to trade based on information obtained through a breach of fiduciary duty involving deception of the source of the information.<sup>105</sup> The rule assigns to the source a limited right to prohibit unannounced trades by its agents on the basis of material, nonpublic information obtained from the source.

Significantly, the misappropriation theory does not encompass all forms of outsider trading advantage. Any original "source" of information, for example, may trade freely on that information. Any outsider trader that obtains the information without breaching a fiduciary duty may trade on the information.<sup>106</sup> Even an outsider trader that does breach her fiduciary duty to the source in obtaining information may avoid misappropriation liability simply by disclosing the theft to the source prior to engaging in trades.<sup>107</sup>

One possible justification for the reach of the misappropriation doctrine is that most misappropriated information represents an

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trading prohibitions. Indeed, even prior to the promulgation of Regulation FD, tippees (people receiving tips from insiders) were prohibited from trading on information on which the tipper herself could not have traded at least to the extent the tipper violated her fiduciary duties (and received a personal gain) from providing the tip and the tippee either knew or reasonably should have known of the breach. See *Dirks v. SEC*, 463 U.S. 646, 662-67 (1983). Despite the derivation from the traded firm, informational advantages based on selective disclosures nevertheless affect the information environment in which outsider traders find themselves and are therefore considered within our outsider trading framework.

104. See *United States v. O'Hagan*, 521 U.S. 642 (1997) (upholding the misappropriation theory of insider trading).

105. See *id.* at 653-56. The misappropriation theory in essence prohibits "fraud on the source." Ayres & Bankman, *supra* note 9, at 255.

106. See, e.g., Bainbridge, *Insider Trading Regulation*, *supra* note 21, at 1621 (arguing that removing the fiduciary duty requirement and taking a property rights approach would allow insider trading prohibitions to reach the "complete stranger" that purloins information from a source).

107. See *O'Hagan*, 521 U.S. at 655 ("[F]ull disclosure forecloses liability under the misappropriation theory . . . if the fiduciary discloses to the source that he plans to trade on the nonpublic information, there is no 'deceptive device' and thus no § 10(b) violation . . ."). The source, nevertheless, may bring a suit under state law for breach of fiduciary duty. See RESTATEMENT (SECOND) OF AGENCY § 388 & cmt. c (1957).



unerodable advantage for the outsider trader.<sup>108</sup> To the extent misappropriated information otherwise would not be available to the general securities markets (regardless of any lawful effort expended in duplicating such information), outside investors may lose confidence in the market. Moreover, to the extent the unerodable advantage is typically casually acquired, banning the use of such information in trades will not adversely affect incentives to generate new information.<sup>109</sup>

The focus on whether information is unerodable, however, ignores several effects of informed trading upon social welfare. First, trades based on even unerodable advantages may increase social welfare as the trades incorporate new information into the stock market price. When a state lottery selects a specific manufacturer to provide video poker machines in the state (and keeps the information confidential),<sup>110</sup> trades on the part of a misappropriating lottery official may result in a shift in the stock market price of the manufacturer (and its competitors) to reflect such information indirectly. Second, trades based on erodable advantages are not always beneficial from a societal perspective. To the extent multiple investors compete with one another in a race to obtain an erodable advantage (even for a short period of time), they will incur potentially costly and duplicative research costs.

Another justification for the misappropriation doctrine is the need to protect the original source's ability to profit from the use of information. In the literature this is sometimes referred to as the "property rights rationale."<sup>111</sup> Without such protection, the original source may

108. See Brudney, *supra* note 15, at 354 (setting forth the unerodable advantages theory of insider trading liability); see also *supra* note 22 (detailing how the present misappropriation doctrine does not precisely track the unerodable advantages theory).

Not all information that would fall under the misappropriation theory, however, meets the definition of an unerodable information advantage. For example, Fidelity may expend resources in developing information on the correct valuation of IBM. Such information is erodable in the sense that others in the market may lawfully (with a similar expenditure of resources) duplicate the information. Nevertheless, when a Fidelity analyst engages in personal trades based on such information in breach of her fiduciary duty (hiding the trades from Fidelity), she will run afoul of the misappropriation doctrine.

109. See *supra* note 15 (discussing Brudney's limitation on the concept of unerodable advantages to only casually acquired advantages); see also Brudney, *supra* note 15, at 362 (arguing that unerodable information advantages based on information related to a trader's "knowledge of the price impact of his contemplated later purchases or sales" should nevertheless be allowable because prohibiting such an advantage "would require a sharing of valuations and judgments, and pro tanto reduce the rewards for risks undertaken by buyers, without reducing the risks or allocating the diverted part of the reward to a new risk taker").

110. See *supra* note 7 (describing the *United States v. Bryan* case).

111. See, e.g., *United States v. Chestman*, 947 F.2d 551, 576-77 (2d Cir. 1991) (en banc) (Winter, J. dissenting) ("Information is . . . expensive to produce, and, because it involves facts and ideas that can be easily photocopied or carried in one's head, there is a ubiquitous risk that those who pay to produce information will see others reap the profit from it. . . . If  
HeinOnline -- 101 Mich. L. Rev. 349 2002-2005

have a reduced incentive to generate the information.<sup>112</sup> If protecting the source justifies the misappropriation theory, however, puzzles remain. The doctrine's emphasis on fiduciary duty, for example, allows thieves and eavesdroppers to make use of purloined information.<sup>113</sup> In response, Stephen Bainbridge has argued for a more explicit property rights approach, arguing that the misappropriation doctrine should turn on a simple question: "did the defendant convert nonpublic information belonging to another for personal gain?"<sup>114</sup> In the case of a thief, the misappropriation theory would apply under Bainbridge's proposal to the extent the thief violated the relevant state law prohibitions against theft of confidential information.<sup>115</sup> Sources of information would then be able to retain the benefit from information production, encouraging such production.

Our earlier internalization analysis suggests, however, that the property rights rationale gives an investor — assuming the investor is the source of its own information advantage — incomplete incentives from a social perspective in deciding how much to engage in information research. Each individual investor internalizes only its expenditures to obtain information and its expected benefit from the use of this information, ignoring the cost to uninformed shareholders as well as the benefit to such shareholders (as well as to third parties) from the increase in accuracy due to informed trades. In addition, many sources of information may already enjoy sufficient incentives to create information even without property rights-type protection. Casually

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the law fails to protect property rights in commercial information, therefore, less will be invested in generating such information."); see also Bainbridge, *Incorporating State Law*, *supra* note 12, at 1252-57; Bainbridge, *Insider Trading Regulation*, *supra* note 21, at 1591 ("The insider trading prohibition ought to be viewed as a means of protecting property rights in information, rather than as a means of preventing securities fraud."); Dennis W. Carlton & Daniel R. Fischel, *The Regulation of Insider Trading*, 35 STAN. L. REV. 857, 861 (1983); Edmund W. Kitch, *The Law and Economics of Rights in Valuable Information*, 9 J. LEGAL STUD. 683, 718-19 (1980).

112. Note, however, that the misappropriation theory may generate insider trading liability for breaches of a wide variety of relationships of trust and confidence that have little to do with the generation of information. For example, the misappropriation theory applies to breaches of "family" relationships of trust. See 17 C.F.R. § 240.10b5-2 (2001). Breach of the relationship between a psychiatrist and patient may also give rise to misappropriation theory liability. See, e.g., *United States v. Willis*, 737 F. Supp. 269 (S.D.N.Y. 1990).

113. In considering the rare complete stranger case, Bainbridge states "one thinks of the scene in WALL STREET in which Charlie Sheen's character breaks into an office." Bainbridge, *Insider Trading Regulation*, *supra* note 21, at 1621.

114. See *id.* On the other hand, to the extent the source of information has an incentive to protect its own information and state laws exist to prohibit the theft of information, the magnitude of information misappropriation that occurs through theft and eavesdropping may not amount to much.

115. *Id.* Bainbridge's approach would therefore do away with odd results stemming from the O'Hagan opinion. For example, under *O'Hagan*, Bainbridge notes that the "brazen misappropriator" that takes information from the source and then simply discloses the theft to the source may trade without violating insider trading laws. See *id.* at 1633-34.

acquired non-trading information, for example, will continue to be produced regardless of legal protection under the misappropriation theory.<sup>116</sup> While it is superficially attractive to protect the hard-earned profits of a source that deliberately acquired the information, it is simply not the case that trading on such information will necessarily increase social welfare.

Others have moved away from focusing on property rights-based rationales to consider the capital market impacts of information advantages in the context of the misappropriation theory. Adam Pritchard, for example, has made the argument that the present misappropriation doctrine in fact protects “the integrity of the stock market” and thereby capital formation and liquidity in the markets.<sup>117</sup> Focusing on investor confidence as important to capital formation and market liquidity, Pritchard argues that information advantages differ based on how a trader obtains the information. Where the trader obtains an information advantage through a fiduciary breach and not through her own hard work and diligence, other investors will lose systematically and demand a greater price discount at the time they initially purchase shares.<sup>118</sup> Market makers, similarly at a disadvantage, will increase their bid-ask spread to the detriment of all investors.<sup>119</sup> On the other hand, Pritchard argues that traders who obtain an information advantage through their own hard work should be able to profit from such an advantage. Through such efforts, the market’s informational efficiency is enhanced.<sup>120</sup> Pritchard then supports the present misappropriation theory with the argument that the theory’s focus on the presence of a fiduciary duty breach divides traders into

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116. See Hirshleifer, *supra* note 90, at 570-72; see also Brudney, *supra* note 15, at 356-57 (arguing that “[i]nformation about the value of securities that is legitimately acquired in circumstances that preclude the acquirer from disclosing it or suggest that his source will not disclose it to others is not generally accumulated for use by its possessor in personal trading in securities . . . and therefore the incentive for personal gains from trading is not necessary to induce those few to pursue it”).

117. Pritchard, *supra* note 13, at 48. Pritchard also supports the misappropriation doctrine as a sensible interpretation of Section 10(b) of the Exchange Act. See *id.* at 54 (“The disclosure duties imposed by the common law of agency provide a rational, comprehensible basis for determining whether an agent’s breach of duty constitutes a deception within the meaning of § 10(b).”).

118. See *id.* at 49 (“Investors are reluctant to play in what they perceive to be a rigged game. At a minimum, they must be compensated for bearing the risk that the game is fixed.”).

119. See *id.* at 50.

120. See *id.* at 51 (“These [information-related research] efforts are essential to the informational efficiency of the stock market. Accordingly, the misappropriation theory does not interfere with the legitimate processes that lead to efficient pricing of securities in the way that a broader parity of information theory might.”).

those who engage in beneficial information research and those who do not.<sup>121</sup>

Pritchard's arguments, nevertheless, are vulnerable to at least three possible criticisms. First, not all information obtained without a breach of a fiduciary duty is due to the hard work of the trader; for example, a casual eavesdropper is not covered under the present misappropriation doctrine.<sup>122</sup> Moreover, because the misappropriation theory is based on deception, a person may trade on information obtained through a fiduciary duty breach so long as they are open about the breach with the source of the information.<sup>123</sup>

Second, even information obtained through a breach of fiduciary duty and used in securities transactions may help enhance the informational efficiency of the markets. Consider Frank. Frank works for the Axlon Inc. and learns about a confidential product strategy shift on the part of Axlon that casts a positive light on Texon's valuation.<sup>124</sup> Suppose that Frank expends \$2 to steal the Axlon product shift information.<sup>125</sup> Moreover, Frank gains \$100 from using the information in trades with uninformed Texon shareholders. Conversely, uninformed Texon shareholders lose \$100. Trades based on the information also increase the accuracy of Texon's stock, resulting in a \$10 overall gain to investors and third parties. Even though Frank expends only \$2, to the extent his theft does not affect Axlon's shift in product strategy,<sup>126</sup> Frank's activities have resulted in a net social gain of \$8.

Third, even information obtained through hard work may not increase social welfare. Traders may engage in costly duplicative research to obtain an advantage over one another.<sup>127</sup> Traders competing

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121. See *id.* at 51 ("At the same time, however, the misappropriation theory has natural limits, implicit in the common law of agency, that make its application predictable and prevent it from becoming the 'parity of information' theory that Powell feared. By limiting the misappropriation theory to information obtained in breach of a duty, the common law of agency protects individuals who have gained their informational advantage through superior insight or hard work."); cf. Kronman, *supra* note 12, at 9-18 (making the argument in the contract law setting that parties should not be forced to disclose information where the disclosure would undermine their incentives to engage in socially beneficial information research).

122. See *supra* note 113.

123. See *supra* note 115 (discussing the "brazen" misappropriator).

124. Information generated on the product strategy shift is an example of what this Article terms "non-trading information." Such information is created without regard to the trading profits from such information. See text accompanying note 85; Kronman, *supra* note 12.

125. For example, Frank may have to stay late at work to purloin the information without knowledge of anyone else at Axlon, imposing a personal cost of \$2 on Frank.

126. For example, even though Frank trades Texon's securities based on the information, the information may remain confidential enough to allow Axlon to move forward with its new product strategy.

127. See Eugene F. Fama & Arthur B. Laffer, *Information and Capital Markets*, 44 J. BUS. L. 289 (1971); Hirshleifer, *supra* note 90, at 572.

with one another will dissipate their trading profits, ignoring the negative effect their activities have on other traders.<sup>128</sup> Moreover, where the information would otherwise have entered into the public capital markets in any case, such information expenditures result in little accuracy benefit. Indeed, the less spent in providing information to the market, all other things being equal, the higher is the social welfare.

In sum, Pritchard's justification for privileging a source's hard-earned investments in material, nonpublic information is unpersuasive because the outside source acting privately is not well placed to decide whether the research and informed trading is on net socially beneficial. Counter to Pritchard's argument, it is not even clear whether the outside source (operating in the absence of the traded firm's consent) is better placed than the agent in deciding whether to engage in informed trading.

Kimberly Krawiec, like Pritchard, has tried to assess the misappropriation theory taking into account the needs of investors and the capital markets.<sup>129</sup> But in contrast with Pritchard, Krawiec argues that insider trading prohibitions should apply only to corporate insiders, constructive insiders, and tippees of such insiders.<sup>130</sup> Everyone else, under her system, would be deemed "corporate outsiders" and enjoy full freedom to engage in trades regardless of the source of information.<sup>131</sup> Thus, an eavesdropper would have the ability to use information she obtained from a firm to engage in trades in the firm's securities. Likewise, a reporter would be able to take information from an upcoming newspaper article and trade based on the information even without the newspaper's consent.

In essence, Krawiec's proposal eliminates the misappropriation theory in its entirety, leaving only the classical insider trading doctrine. In doing so, Krawiec contends that the lack of insider trading prohibitions for misappropriated information will not necessarily result in the rampant theft of information. Rather, Krawiec's proposal simply shifts the burden of protecting the source's property rights to the source itself through private contract.<sup>132</sup> Moreover, Krawiec argues that her proposal brings clarity to insider trading law through the

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128. One could respond that the net social harm from duplicated information expenditures is therefore self-limiting. Nevertheless, the duplicated information research costs necessary to reach zero economic profits (and thus the self-limiting point for research) may be substantial. See text accompanying notes 93-96.

129. See Krawiec, *supra* note 22.

130. See *id.* at 498.

131. See *id.*

132. See *id.* at 498-99. Jill Fisch, similarly, recognizes that alternative remedies exist for misappropriation. See Fisch, *supra* note 9, at 207 (noting that "standard criminal laws" including laws dealing with embezzlement can deal with instances of misappropriation).

complete elimination of insider trading prohibition where outsider trading does not involve an insider tip.<sup>133</sup>

But as discussed above,<sup>134</sup> allowing outsider traders to engage freely in trades does not guarantee the optimal level of information production. Outsider traders may engage in duplicative information research from a societal perspective. Even where outsider traders do not engage in duplicative research, they ignore the loss to uninformed investors from their trades. Outsider traders also ignore the accuracy benefit their trades have for securities market prices.<sup>135</sup>

Because outsider traders sometimes have an incentive to engage in too much or too little research, it is difficult for regulators to decide *ex ante* which types of outside informed trading are socially beneficial (and hence permitted) and which types are socially detrimental (and hence prohibited). Determining what informational disparities maximize investor welfare is specific to particular traded firms and depends on the situation surrounding a particular disclosure. For example, small investors may not suffer great harm to the extent they may simply invest through large institutional investors, essentially purchasing the informational resources of the institutional investors. Careful balancing of the harm to small, uninformed investors from being at an informational disadvantage against the benefits to stock price accuracy and information production from allowing such advantages is therefore required. The misappropriation theory fails to make this balance through its blanket prohibition of some types of outside information advantages but not others. But in any event, those that support the misappropriation theory ignore the 800-pound gorilla sitting in the

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133. See Krawiec, *supra* note 21, at 499 (stating that “privatizing the law of outsider trading lends clarity to the regulatory scheme by permitting under federal law all outsider trading that does not involve an insider tip”).

134. See *supra* Section II.A (discussing the social costs and benefits of outsider information research).

135. Jill Fisch also recognizes the limits of both classical and misappropriation insider trading theories in failing to reach all problematic instances where an information advantage exists in the securities markets. See Fisch, *supra* note 9, at 216-17 (noting that a supplier trading the securities of a corporation using information obtained from the supplier’s relationship with the corporation may pose the “same dangers of manipulation of corporate events and harm to the corporation as trading by insiders”). In dividing problematic information advantages from nonproblematic advantages, Fisch relies on the notion that corporate insiders of public corporations owe a duty to the marketplace. See *id.* at 227-28 (arguing that such a duty is fair given that “the corporate insider’s superior access, due to his position, may be partially attributed to government and public participation in the markets”). Fisch argues that her focus allows insider trading liability to focus on ensuring the integrity of the mandatory disclosure system, limiting the incentive of managers to manipulate the disclosure of corporate information to increase insider trading profits, and on maintaining “objectives of market fairness”. *Id.* at 239. Fisch’s notion of fairness, however, derives from Brudney’s theory of “unerodable” information advantages, see *supra* notes 15-24 and accompanying text, and therefore ignores the various costs and benefits of information research discussed in this Article.

room<sup>136</sup> — that is, the traded firm itself, which is much better situated to decide whether particular classes of informed trading are socially beneficial but are disenfranchised under the present regime.

### B. Rule 14e-3 Tender Offer Rule

When any person initiates a tender offer for an Exchange Act reporting company's stock,<sup>137</sup> a special prohibition against the use of nonpublic material information goes into effect under Rule 14e-3 of the Exchange Act.<sup>138</sup> Once a tender offer is initiated, Rule 14e-3 prohibits any person other than the potential acquirer from trading based on nonpublic material information obtained from the target company, the acquirer, or an officer or director of either, among others.<sup>139</sup> Unlike the misappropriation theory, the prohibition extends regardless of the presence of deception or the breach of a fiduciary duty.

Rule 14e-3's specialized approach with respect to tender offers, in turn, might be justifiable to the extent the SEC has to make an all-or-nothing command and control decision. In the absence of Rule 14e-3-like restrictions, affected firms might have to invest excessive resources in maintaining security to ascertain that outsiders did not obtain information about a tender offer. Like the inefficiency of excessive locks in the absence of burglary laws,<sup>140</sup> the absence of outsider trading restrictions would likely induce excessive victim precaution to insure that Gordon Geckos of the world did not disrupt or free ride on an acquirer's acquisition plans.<sup>141</sup> Mere reliance on

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136. Neither author has actually ever been in a room with an 800-pound gorilla. It must be noted that the average weight of a male gorilla is actually between 300 and 500 pounds. *See About Gorillas*, at <http://www.koko.org/about/facts.html> (last visited Apr. 28, 2002).

137. The Securities Exchange Act of 1934 imposes periodic information reporting requirements for certain issuers, commonly known as "Exchange Act reporting companies". Companies listed on a national securities exchange must register and comply with the SEC's periodic information disclosure requirements. *See* 15 U.S.C. §§ 78m(a), 78l(b) (2000); *see also* 15 U.S.C. § 78(c)(a)(1) (2000) (defining "exchange" for the purposes of the Exchange Act). Companies whose total assets exceed \$10 million and have a class of equity security (other than an exempted security) held of record by more than 500 shareholders must register the securities under the Act and thereby come under the periodic reporting requirements of 15 U.S.C. § 78m(a). *See* Securities Exchange Act of 1934, 15 U.S.C. §§ 78l(g), (l); *see also* 17 C.F.R. § 240.12g-1 (2001) (raising the asset requirement to \$10 million).

138. Rule 14e-3, takes effect when "any person has taken a substantial step or steps to commence, or has commenced, a tender offer . . ." 17 C.F.R. § 240.14e-3 (2001).

139. *See* 17 C.F.R. § 240.14e-3 (2001). Note that the acquirer is not included within the reach of Rule 14e-3. Nevertheless, the Williams Act imposes other restrictions on the ability of the acquirer to purchase stock that increase the acquirer's ownership above five percent in the target company. The rule prohibits trading in the stock of the target company in a tender offer, but does not prohibit informed trading on related firms. *See* Ayres & Bankman, *supra* note 9, at 243.

140. *See* RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* 204 (3d ed. 1986).

141. Gordon Gecko, of course, is a reference to the 1987 movie *Wall Street* starring Michael Douglas and Charlie Sheen. *See* WALL STREET (Twentieth Century Fox 1987).

misappropriation restrictions would not be sufficient because as adumbrated above, outsiders (like the casual or deliberate eavesdropper) who are not in contractual privity with the affected firms are not covered by misappropriation trading restrictions.

But even here the SEC does not need to make an all-or-nothing command and control decision. Even our realization that misappropriation doctrine is insufficient is not the same as saying that Rule 14e-3 liability needs to be mandatory. We could imagine an alternative regime in which the Rule 14e-3 trading restrictions were merely defaults that could be waived by board resolution of the acquiring and target boards.<sup>142</sup> Consistent with the general thrust of this Article, if the affected firms consented to such outsider trading (and they had publicly disclosed that they had consented to such outsider trading), we can see no reason why the trading should not go forward.<sup>143</sup> Let us quickly add that we predict that such consent by both the acquiring and traded firms would rarely be forthcoming,<sup>144</sup> so on a pragmatic level we do not see much of an efficiency loss involved in making the Rule 14e-3 trading restrictions waivable by the affected firms.

### C. Regulation FD

The securities laws also attempt to move beyond classical insider trading prohibitions to take a more expansive approach to informa-

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142. We would subject to much higher self-dealing scrutiny opt outs that allowed managers to trade on the basis of tender offer information. See *infra* Section IV.A.2 (discussing methods of dealing with the problem of managerial self-dealing under the Article's proposal).

143. Adam Pritchard, on the other hand, has made the observation that Rule 14e-3's prohibitions against trades in the target firm's stock should not be waivable by a potential acquirer. Without Rule 14e-3, a potential acquirer could tip off favored arbitrageurs in return for the agreement on the part of the arbitrageurs to tender their shares to the acquirer. Arbitrageurs that failed to tender would not receive a tip the next time the acquirer seeks to make an acquisition, leading to the possibility of coercive tender offers. See E-mail from Adam Pritchard to authors (Oct. 2, 2001) (on file with authors). To the extent we would require waiver on the part of the target company to reduce the scope of Rule 14e-3, however, our proposal avoids the problem of coercive tender offers that Pritchard mentions.

144. The acquiring firm would rarely waive because doing so would drive up the cost of acquiring a toe-hold position in the target. We would not allow a target firm to unilaterally waive the Rule 14e-3 duty against informed tender trading because doing so might entrench management by reducing the prospective profitability of a takeover.

Waiving the trading restriction might create possible benefits to the traded firms in terms of stock price accuracy. But we are skeptical that in a tender offer context that the short term increase in price accuracy would outweigh the need for secrecy. A more important possibility is that the firms might grant limited waivers to entities that helped facilitate the merger, but we are hard pressed to argue that granting trading rights would dominate non-trading compensation.



tional disparities through Regulation FD of the Exchange Act.<sup>145</sup> Applying only to Exchange Act reporting companies,<sup>146</sup> Regulation FD focuses on selective disclosures of nonpublic material information from specified sources within the traded firm to a delineated subset of outside market participants. Top company executives as well as employees whose primary responsibility involves communication with shareholders, among others, are included among company sources that fall within the ambit of Regulation FD.<sup>147</sup> Outside market participants that receive such selective disclosures and fall under Regulation FD include securities brokers, investment analysts, investment companies, and any investor reasonably expected to trade based on the information.<sup>148</sup> When a specific company source makes a selective disclosure to one of the delineated outside market participants, Regulation FD then works to make the disclosure unlawful to the extent the company does not also disclose the information to the public securities markets.<sup>149</sup> Where the selective disclosure is intentional, Regulation FD requires that the traded firm simultaneously make the disclosure also to the entire market.<sup>150</sup> If unintentional, the traded firm has the lesser of twenty-four hours or when the NYSE commences trading to disclose the information to the entire market.<sup>151</sup>

The Article's internalization framework, nonetheless, calls into question the blanket prohibition on the use of nonpublic material information within the traded firm to favor particular market participants selectively. Although the provision of an information advantage will certainly harm uninformed investors, selective disclosures may re-

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145. See SEC, Selective Disclosure and Insider Trading, *supra* note 5; see also *supra* note 103 (discussing the relationship of Regulation FD and classical insider trading prohibitions including tipper-tippee liability).

146. See *supra* note 137 (defining Exchange Act reporting companies).

147. See Regulation FD, 17 C.F.R. § 243.101(b) (2001), (defining "issuer" to encompass primarily Exchange Act reporting companies); see also Regulation FD, 17 C.F.R. § 243.101(c) (2001) (stating that a "Person acting on behalf of an issuer" means any senior official of the issuer (or, in the case of a closed-end investment company, a senior official of the issuer's investment adviser), or any other officer, employee, or agent of an issuer who regularly communicates with any person described in 17 C.F.R. § 243.100(b)(1)(i), (ii), or (iii), or with holders of the issuer's securities").

148. See Regulation FD, 17 C.F.R. § 243.100(a) (2001) (requiring issuers to make public disclosures of nonpublic material information disclosed selectively to persons described in Rule 100(b)(1) of Regulation FD).

149. See *id.*

150. See Regulation FD, 17 C.F.R. § 243.100(a)(1) (2001) (requiring simultaneous disclosure in the case of intentional selective disclosure).

151. See Regulation FD, 17 C.F.R. § 243.100(a)(2) (2001) (requiring disclosure "promptly" in the case of unintentional selective disclosures); Regulation FD, 17 C.F.R. § 243.101(d) (2001) (defining "promptly"). Note that Regulation FD specifically excludes the possibility of private causes of actions based on violations of Regulation FD to reduce the chilling effect from nuisance suits. See SEC, Selective Disclosure and Insider Trading, *supra* note 5.

sult in non-trading benefits for the traded firm and its shareholders. The promise of selective disclosures, for example, may induce an analyst to initiate coverage of a particular company. Likewise, selective disclosures may also help compensate an investor for taking on the undiversified risk of assembling a block of shares in situations where the block monitors management for agency problems.<sup>152</sup>

The key point is not that selective disclosures are always beneficial to the traded firm and its shareholders. Indeed, opportunistic managers may make use of selective disclosures to favor analysts and outside block shareholders, in return for support of the managers' self-interested policies.<sup>153</sup> Rather, selective disclosures may provide net benefits in certain specific instances. Whether such disclosures are used to induce an analyst to research the traded firm or to compensate large block investors in forming their blocks of shares, the value of the traded firm may increase. Particularly for selective disclosures, the traded firm as the source of the information will internalize much of the disparate effects. Once again, command and control prohibitions based on regulators' decisions of what is right and what is wrong are not the answer. Regulators, instead, should step back from prohibiting the use of information as a mandatory matter and instead rely on the traded firm (with appropriate safeguards against managerial self-dealing) to make such determinations.

#### IV. INTERNALIZING OUTSIDER TRADING

Under the Article's framework, no single market participant internalizes all the various effects from informed trading. But the trader and the traded firm jointly internalize the vast majority of the effects related to social efficiency. This Part sets forth the proposal that the market, and not regulators, should determine the level of permissible information advantages among investors.

##### A. *The Outsider Trader Dilemma*

The Article's analysis calls into question the laissez-faire approach to outsider trading. Left to their own devices, outsider traders take into account far fewer consequences from the decision to engage in information research to profit from securities trades than a traded firm would take into account in deciding whether to allow its insiders

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152. See Ian Ayres & Peter Cramton, *Relational Investing and Agency Theory*, 15 CARDOZO L. REV. 1033, 1062-63 (1994) (arguing that block shareholders with a long-term relationship with management may serve to monitor for agency problems and help implement optimal implicit contractual arrangements).

153. For a detailed discussion of the problem of managerial opportunism through selective disclosures, see Choi, *supra* note 5.

to engage in insider trading. Informed outsider traders, for example, completely ignore the corresponding trading losses uninformed investors receive due to the informed trades. And outsider traders also ignore any accuracy benefit from their trades on securities market prices not only to third parties but to other investors in the traded firm. For those that support the regulation of insider trading, therefore, outsider trading should pose an equally appealing target for regulation.

We hesitate, however, to suggest that the government get involved in the direct regulation of outsider trading. Government regulation itself is not without costs. And the costs of government regulation may be even higher for outsider trading compared with the regulation of insider trading. In the insider trading context, regulators take a “corner solution” approach and simply ban all insider trades based on material nonpublic information.<sup>154</sup> Such a one-size-fits-all approach, however, is not presently taken in the outsider trading context. Indeed, Rule 14e-3 and the scope of the present misappropriation doctrine provide a variegated landscape of allowable and disallowed types of outsider trading.<sup>155</sup> Firms with different types of investors and market capitalization, moreover, may prefer varying levels of informed outsider trading.<sup>156</sup> Regulators may lack information on the precise level of outsider trading that maximizes a particular firm’s value. Regulators may also act only slowly to adjust the level of outsider trading to changed circumstances in any particular firm. Moreover, once regulators attempt to provide more tailored regulation for particular firms, regulators may face an increased risk of coming under the influence of the various securities market professionals, leading to regulations less designed to increase overall social welfare and more tailored toward the interests of such groups.<sup>157</sup>

Instead, we look to another possible source of regulation: the traded firm itself. This Article proposes that regulators should focus on the traded firm as the agent for internalization. If the traded firm consents *ex ante* to a particular type of informed trading and if the

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154. Pritchard, *supra* note 13, at 18-19 (describing the “classical” theory of insider trading).

155. See *supra* Part III (describing the present regulation of outsider trading).

156. See *supra* notes 135-136 and accompanying text.

157. See, e.g., Gary S. Becker, *A Theory of Competition Among Pressure Groups for Political Influence*, 98 Q.J. ECON. 371 (1983); George J. Stigler, *The Theory of Economic Regulation*, 2 BELL J. ECON. & MGMT. SCI. 3 (1971). In the securities law context, the securities bar and underwriters have influenced what courts and the SEC have required for due diligence under section 11 of the Securities Act of 1933. See Reinier H. Kraakman, *Gatekeepers: The Anatomy of a Third-Party Enforcement Strategy*, 2 J.L. ECON. & ORG. 53, 83 (1986) (“Over the years, the securities bar and the underwriting community have honed the chief Section 11 investigation — the underwriter’s due diligence investigation — into model verification procedures.”); Jonathan R. Macey, *Administrative Agency Obsolescence and Interest Group Formation: A Case Study of the SEC at Sixty*, 15 CARDOZO L. REV. 909 (1994).

outsider trader actually proceeds to trade on such information, then their combined revealed preference strongly signals that such trading is socially valuable. Some may question whether in fact a traded firm will find it feasible to distinguish and restrict informed trading among potentially thousands of secondary market trades daily. Nonetheless, several possible mechanisms exist.<sup>158</sup> Through trading delays coupled with disclosure on intended trades, for example, regulators may force those with information to signal their information to the market prior to their trades, reducing the profit from informed trades.<sup>159</sup> Those investors who do not face a delay — pursuant to the traded firm's consent — may then profit from observing the trade signals of those facing a trading delay. Moreover, compared with the insider trading context, our proposal's reliance on the traded firm poses fewer third party externality and managerial self-dealing problems. Before turning to the details of our proposal, we discuss the two most serious limits to our internalization thesis: externalized benefits from informed trading and self-dealing problems.

### 1. *Third-Party Externalities*

The internalization proposal depends on the ability of the firm whose securities are being traded to internalize all the different effects of information disparities in the market. Firms, however, may ignore the benefit of increased stock price accuracy to third parties that look to stock price in making decisions.<sup>160</sup> Competitors, for example, may look to a rival firm's stock price in determining whether to enter a new product market.<sup>161</sup> Zohar Goshen and Gideon Parchomovsky, similarly, argue that analyst-driven information research provides positive externalities to the entire securities information market that individual analysts and firms fail to capture.<sup>162</sup> They argue, for example, that multiple analysts help build up a common information pool that may assist other analysts in their efforts to value companies.<sup>163</sup>

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158. We discuss these mechanisms more fully *infra* Section IV.B.3.

159. See text accompanying notes 280-296 (discussing the Article's delayed-trading rule proposal).

160. See also *supra* note 58 (discussing various ways third parties may benefit from more accurate securities prices).

161. On the other hand, externalities exist in all areas of social interaction. Suppose I purchase a magazine in New Haven and then travel to Berkeley. When I throw that magazine away in Berkeley, I contribute to the trash in Berkeley without internalizing the impact on the city's residents. Nevertheless, not all externalities necessarily require regulatory intervention. Regulators, for example, may suffer from a lack of expertise and therefore make mistakes. The administrative costs of dealing with all externalities, as well, may be prohibitive.

162. See Goshen & Parchomovsky, *supra* note 5.

163. See *id.*

Greater amounts of freely flowing information also may induce more investors to educate themselves about the financial markets, increasing confidence in the markets.<sup>164</sup>

There are, to our minds, strong answers to each of these criticisms. First, an individual company will in fact internalize many of the positive effects to its own investors from more accurate securities prices for information research specific to that particular company.<sup>165</sup> Where having several analysts actively following the company generates superior information and a large reduction in each analyst's research costs compared with a smaller number of analysts, the individual company will then have an incentive to induce multiple analysts to engage in informed trades. In some situations, in fact, a company may wish to reverse the flow of cash, actively subsidizing the efforts of analysts and other sources of information on the company's securities through selective disclosures and other forms of compensation.<sup>166</sup>

Second, the magnitude of the positive information externality is crucial. Firms already take into account many of the benefits from more accurate securities prices.<sup>167</sup> Particularly to the extent the costs and benefits to a firm's shareholders from allowing information research often varies, only a large positive externality (above the level firms internalize) may lead one to think that always allowing analysts to engage in research is worthwhile. Significantly, Goshen and Parchomovsky ignore the possibility that too much information research may reduce overall social welfare. Where two independent analysts engage in duplicative information research, the additional expenses result in a social loss without any increase in informational efficiency.<sup>168</sup> Having multiple analysts engaging in duplicative information

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164. See *id.* Along a similar vein, Jack Coffee makes the argument that analysts perform a valuable function in increasing market efficiency. See Coffee, *supra* note 92, at 723-24 (stating that "most accounts explaining the stock market's efficiency assign a substantial responsibility to the competition among analysts for securities information"). Analysts, however, do not capture the full benefit of their activities because information is a public good. See *id.* at 726. Coffee therefore advocates mandatory disclosure as a means of subsidizing the research efforts of market analysts. See *id.* at 729. Nevertheless, absent positive externalities that affect the research of other firms, it is unclear why firms do not already internalize the benefit from a more efficient stock market price and therefore have close to full incentives to subsidize the efforts of analysts voluntarily.

165. See text accompanying notes 53-58; see also Romano, *supra* note 58, at 2368 (arguing that investors with diversified portfolios will internalize the benefit of accurate securities prices across all firms in their portfolio).

166. A small company, for example, may use selective disclosures to entice analysts to initiate coverage of the firm. Analysts incur a fixed cost to cover any particular firm. Small firms provide the analyst a lower securities volume and clientele interest level upon which to spread the fixed cost. Selective disclosures therefore may help subsidize the analysts fixed costs to cover the firm. See Choi, *supra* note 5, at 545.

167. See text accompanying notes 53-58.

168. See text accompanying notes 91-96 (discussing the possibility of duplicative information research costs among outside investors).

research, moreover, may not add much to the common pool of available information. Not all information provides the same benefit to the common pool; while a piece of unique, previously unknown information may greatly enhance the pool, duplicative information may not have as great a positive impact.<sup>169</sup>

Measuring the social benefit of this externality should turn on the potential improvement in allocative efficiency and not in the potential for profitable trading opportunities on other stock. The question should be whether the more accurate pricings lead to better substantive decisionmaking in how to deploy or create physical capital. These potential allocative benefits of enhanced pricing are especially likely to be small if the outsider trading works merely to incorporate new information into stock prices shortly before it otherwise would have come to light. Frontrunning the public disclosure of information — even if it affects several stocks — is unlikely to enhance social welfare.

Even where externalities are significant, this does not justify retaining the present outsider-trading regime that gives outside investors and analysts free reign to engage in informed trading aside from narrowly defined exceptions.<sup>170</sup> For nonpublic information that is likely to be known by the traded firm, positive externalities perhaps militate toward requiring mandatory disclosure by the traded firm — not laissez-faire outsider trading rights.<sup>171</sup> For such inside information, Jack Coffee, among others, has argued that the existence of strong positive externalities justifies mandatory disclosure rules.<sup>172</sup> If traded firms are privy to nonpublic information that produces net social benefits because of positive third-party externalities, it is better to mandate disclosure than to leave it up to unregulated trading by outsiders. Indeed, the strongest case for our internalization proposal concerns nonpublic information that the traded firm already knows but which the government has deemed inappropriate to mandate disclosure. An outside trader who expends effort to learn what the traded firm already knows (and intends to reveal to the market) produces

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169. There may be a verification benefit to some duplication (as reflected in the adage “measure twice, cut once”). But the traded firm will internalize most of the benefits of verification and hence will have the incentive to allow the optimal level of duplication.

170. See *supra* Part III (discussing the misappropriation, Rule 14e-3, and Regulation FD limits on informed outsider trading).

171. Interfirm externalities encompass positive impacts on competitors when one firm discloses inside information to the market. A competitor, for example, benefits from learning about the disclosing firm’s costs of production. For a discussion of interfirm externalities, see Merritt B. Fox, *Retaining Mandatory Securities Disclosure: Why Issuer Choice is Not Investor Empowerment*, 85 VA. L. REV. 1335, 1345-46 (1999) [hereinafter Fox, *Retaining Mandatory Securities Disclosure*]. One of us, nevertheless, has made the argument that even with the possibility of externalities, mandatory disclosure is not justified. See Stephen J. Choi & Andrew T. Guzman, *Portable Reciprocity: Rethinking the International Reach of Securities Regulation*, 71 S. CAL. L. REV. 903 (1998).

172. See Coffee, *supra* note 92, at 723-33.

few third-party benefits. The outside trader in this circumstance simply profits by “frontrunning” — trading on the nonpublic information before the firm makes it public. A common example of this concern is the frontrunning of a traded firm’s periodic disclosure of its sales or profits. If society is better off having more than quarterly reports of financial statements, government can easily require it. But in the absence of such a requirement, a traded firm should be able to prohibit frontrunning on information that it already possesses but has chosen not to disclose. In the absence of a mandatory disclosure solution, outsider traders have poor incentives to trade only on outside information that is likely to be socially beneficial.

There may exist a narrow category of deliberately-acquired, non-public information to which the traded firms are not privy that are expected to produce positive third-party externalities (not captured by the traded firm or the outsider trader). Allowing outsider trading on such information is likely to be on net socially beneficial. With regard to this circumscribed category, mandatory disclosure requirements are not likely to be effective because the traded firm does not have access to the information and because the outsider trader will not acquire the information if it is required to disclose it before trading. There is a theoretical argument for restricting traded firms’ ability to limit outsider trading with regard to such information. The traded firm — by not internalizing the informational spillovers that benefit third parties — may impose socially inefficient trading restrictions on outsiders. For example, outside analyst forecasts of the weather or future computer chip demand are not firm-specific research but instead may create informational spillovers that enhance allocational efficiency by increasing stock price accuracy of several stocks.

The optimal regulatory response to these potential third-party benefits, however, is not to give outsiders unfettered freedom to trade on any type of nonpublic information. Instead of completely displacing the right of traded firms to restrict informed outsider trading, optimal regulation should merely attempt to limit the ability of traded firms to block outsider trading that is likely to impose net social benefits because of non-internalized third-party benefits.

Traded firms should still have the ability to limit trading on information that is within the traded firm’s own possession. If the airing of such information is deemed to be socially beneficial it should be produced for the market by mandatory disclosure and not by the duplicative efforts of outsiders trying to unearth what the traded firm already knows. In particular, we see no reason why a traded firm should not have the right to restrict outside traders from frontrunning on financial information that is already subject to quarterly mandatory disclosure.

We believe that traded firms should also have the ability to limit trading on information that will be made available to the market

within a reasonable period of time. Even unearthing information that is not currently within the traded firm's possession may provide few third-party benefits if the information is of a type that will naturally be made public to the market. Thus, for example, we believe that a traded firm should have the right to restrict outsider trading on the basis of nonpublic information concerning impending government decisions. Frontrunning by a few days the disclosure of a patent award or a Delaware court decision is likely to produce relatively few third-party allocative benefits.

Lastly, we believe that traded firms should have the ability to limit trading based on "immaterial" information. So-called "noise" traders, who trade on information that is not related to the underlying fundamentals of a traded firm, can reduce stock price accuracy if they exhibit herd behavior and drive the stock price values away from fundamentals.<sup>173</sup> Noise trading can hurt both the traded firms' shareholders and third parties. Thus, while we have normally couched our proposal to allow traded firms to control outsider trading based on *material* nonpublic information, we believe there is an even stronger case for allowing a traded firm to restrict outsider trading based on *immaterial* nonpublic information.<sup>174</sup>

Hardcore supporters of unfettered outsider trading on the grounds of ubiquitous third party benefits are hard pressed to explain the presence of limits on outsider trading imposed through, among other provisions, Rule 14e-3 of the Exchange Act.<sup>175</sup> Rule 14e-3's prohibition against informed outsider trading relating to a tender offer reduces stock price accuracy and thus refutes the idea that third-party price accuracy benefits must everywhere and at all times trump other considerations. Consonant with our foregoing theory, the third-party benefits from outsider trading are likely to be small in the tender offer context because the tender offer will be publicly announced in a reasonably short time.

There is no reason to think that Rule 14e-3 exhausts the class of cases where the social benefits are outweighed by other factors. Allowing outside traders to front run a tender offer announcement inefficiently and inequitably transfers values from the tender offer to the outside trader. Allowing outside traders to front run a quarterly report inefficiently and inequitably transfers value from the traded firm's shareholders to the outside trader.

Indeed, hardcore supporters of unfettered outsider trading should be driven to call for a suppression of what we have called the

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173. See Andrei Shleifer & Larry Summers, *The Noise Trader Approach to Finance*, 4 J. ECON. PERSP. 19 (1990).

174. We are grateful to Joe Bankman for providing this idea.

175. For a discussion of Rule 14e-3, see *supra* Section III.B.



“Laidlaw rights” of uninformed traders. Just as Laidlaw famously asked a seller whether “there was any news which was calculated to enhance the price or value of the article about to be purchased,”<sup>176</sup> uninformed block traders often require their trading partners to reveal the identity of the true party in interest and to warrant that they do not possess any nonpublic information. But allowing uninformed traders to extract warranties of this kind restricts the ambit for profitable outsider trading on the basis of nonpublic information and thus dampens the potential third-party pricing benefits of such trades. Strong-form belief in third-party benefits drives one to suspend Laidlaw rights as well as Rule 14e-3 duties.<sup>177</sup> The absence of such proposals, however, indicates that few people truly believe that third-party pricing benefits are ever present.

In sum, we concede the existence of some positive pricing externalities that are not likely to be considered by the traded firm. But it is implausible to think that the optimal regulatory response is to grant unfettered outside trading rights. Instead, we think optimal regulation will prohibit traded firms from restricting types of outsider trading where external benefits are likely to be large, but will retain the ability of firms to regulate outsider trading where the third-party benefits are likely to be small. As an empirical matter, we believe that the pricing externalities that are not susceptible to mandatory disclosure by the traded firms are likely to be of tertiary importance.<sup>178</sup> Traded firms and outsider traders jointly internalize the vast bulk of socially relevant costs and benefits and therefore using their joint consent to filter whether informed trading takes place is likely to provide a very strong second-best solution. Moreover, relying on the traded firm to determine the scope of outsider trading does not mean that regulators must delegate full discretion to the traded firm. Instead, even giving traded firms the ability to opt out of the present *laissez-faire* regime and impose limited restrictions on outsider trading based on particular

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176. *Laidlaw v. Organ*, 15 U.S. (2 Wheat.) 178, 183 (1817).

177. We do not think that an uninformed trader’s Laidlaw rights should be suspended by either the government or by the traded firm itself. Under our proposal a traded firm that grants informed trading rights to a single outsider might want to facilitate that trader’s trading opportunities by suspending the ability of uninformed block traders to extract Laidlaw warranties. One could imagine a regime where the traded firm had the ability to render such warranties (between two different parties) unenforceable. But we do not think this would be wise public policy. While the uninformed block trader does not internalize all the social costs and benefits of extracting a Laidlaw warranty, to allow traded firms to suspend the enforceability of such warranties is likely to dry up too much liquidity in the block sales market. In essence, our proposal would allow both the traded firm and the uninformed block trader to independently decide how much to resist the transfer effects of informed trading. We are grateful to Bill Wang and Steve Thel for independently alerting us to this issue.

178. As Richard Painter pointed out to us, the United States lived under the threat of SEC prosecution against all informed outsider trading for roughly twenty years after *Chiarella* without a noticeable decline in stock market efficiency.

classes of information — similar to the approach under Rule 14e-3 — may improve social welfare without greatly reducing the amount of information production in the capital markets.<sup>179</sup>

## 2. *Managerial Opportunism*

The Article puts forth the argument that regulators may assist the ability of a traded firm to internalize the costs and benefits of outsider trading through a shift in the right to control informed outsider trading to the traded firm. On one level, the Article mirrors the argument first advanced by Henry Manne that a traded firm internalizes the costs and benefits of insider trading.<sup>180</sup> The argument for allowing traded companies to control outsider trading is stronger than Manne's insider trading proposal. With insider trading, critics may contend that managers in control of a publicly-held traded firm<sup>181</sup> may force the firm to allow insider trading even when it is not in the best interests of overall corporate welfare.<sup>182</sup> The comparative attraction of the Article's internalization proposal for outsider trading lies in the relative lack of opportunism in a traded firm's decision to allow such trading.

The possibility exists, of course, that managers of traded firms may have self-dealing incentives (which diverge from the shareholders' interests) to grant informed trading privileges to particular outsiders — for example, only to securities firms with “corrupt” analysts willing to do the bidding of managers.<sup>183</sup> We question the magnitude of such incentives in the area of outsider trading, however. While managers of a publicly-held firm will control the decision to allow outsider trading, they will find it difficult to profit directly from the decision. Absent some explicit or implicit relationship between the managers and the

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179. See text accompanying note 218.

180. See Manne, *supra* note 27.

181. See, e.g., Eugene F. Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288, 288-89 (1980); Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J.L. & ECON. 301 (1983); Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 308-10 (1976); Mark J. Roe, *A Political Theory of American Corporate Finance*, 91 COLUM. L. REV. 10, 26-27 (1991) (noting a variety of legal impediments facing shareholders who desire to build up a large block of shares).

182. This is particularly a problem where managers may force firms to engage in a “mid-stream” shift. See Jeffrey N. Gordon, *The Mandatory Structure of Corporate Law*, 89 COLUM. L. REV. 1549, 1573 (1989) (a “mid-stream” change to corporate governance is one imposed by a board of directors — and possibly in the board's self-interest — after the initial incorporation of the firm).

183. The problem of corrupt analysts willing to recommend a traded firm even where not warranted has recently taken center stage in the financial press. See, e.g., Charles Gasparino & Scot J. Paltrow, *SEC Joins Pack, Opens Inquiry Into Analysts*, WALL ST. J., Apr. 26, 2002, at C1 (describing Eliot Spitzer's investigations into analyst recommendations at Merrill Lynch & Co. and other securities firms as New York's Attorney General).

outsider trader, the outsider trader will not share its profit with the managers from engaging in informed trades. The fee the outsider trader may pay to engage in such trades goes directly to the firm. Managers may seek to expropriate some of the fee directly from the corporate treasury. However, direct embezzlement is more observable and therefore more easily punished through state law than other forms of self-dealing.

Managers, of course, may seek a hidden implicit deal with an outsider trader to give the trader the right to engage in informed trades at a discounted price in return for a cut of the trader's profits paid directly to the managers. The risk of such under-the-table transactions, nevertheless, is present in all forms of corporate transactions and is not unique to the sale of the right to engage in informed trades.<sup>184</sup> Just as they do in other self-dealing transactions, state corporate law fiduciary duties provide a general deterrence to hidden side deals between managers and outsider traders.<sup>185</sup> Moreover, compared with insider trading, managers face more hurdles to profit from a hidden side deal with an outsider trader. Managers, for example, must worry that the outsider trader may renege on their implicit agreement. Managers must also contend with the possibility that the payment of funds from the outsider trader to the manager will be detected.<sup>186</sup>

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184. Goshen and Parchomovsky make a similar point in making the argument that the market (and not the government) should regulate selective disclosures at least for small, illiquid traded firms. See Goshen & Parchomovsky, *supra* note 5, at 1272 ("Given that enforcement is the key issue, the potential for abuse of selective disclosure is no different than that of any other fiduciary duty or illegal insider trading.").

185. State corporate law provides the general duty of loyalty under which managers of a corporation operate. Under the duty of loyalty, managers may not profit at the expense of the corporation and shareholders. See *Meinhard v. Salmon*, 164 N.E. 545, 546 (N.Y. 1928) (stating that the duty of loyalty involves the exercise of "the punctilio of an honor the most sensitive"). See generally ROBERT C. CLARK, *CORPORATE LAW* 798-800 (1986) (describing the duty of loyalty under state corporate law). Once managers are engaged in self-dealing, courts review such transactions under the stringent entire fairness standard, placing the burden of proof on the defendants, rather than apply the business judgment rule. See, e.g., *Weinberger v. UOP, Inc.*, 457 A.2d 701, 710-11 (Del. 1983). Delaware provides a variety of procedural means, nevertheless, for directors to cleanse a self-dealing transaction. See DEL. CODE ANN. tit. 8, § 144 (1991). Disclosure and approval by disinterested directors or by disinterested shareholders, for example, are both acceptable means of removing the taint from a self-dealing transaction. See *id.*; *Fliegler v. Lawrence*, 361 A.2d 218 (Del. 1976) (requiring the demonstration of the "fairness" of a self-dealing transaction when the votes of interested shareholders determined a ratifying shareholder vote). For the view that state corporate law fiduciary duties do not effectively control the incentives of managers to profit at the expense of shareholders, see Daniel R. Fischel & Michael Bradley, *The Role of Liability Rules and the Derivative Suit in Corporate Law: A Theoretical and Empirical Analysis*, 71 CORNELL L. REV. 261, 292 (1986) (stating that "[m]any analyses of corporate law assume that liability rules enforced by derivative suits play a fundamental role in aligning the interests of managers and investors. We have shown that this widespread assumption is not supported by either the theory of liability rules, the available empirical evidence, or the structure of corporate law").

186. On the other hand, managers may seek compensation in a more indirect form. For example, managers may grant a large block shareholder the right to engage in informed

In certain specific situations, nevertheless, managers may profit from their ability to control the scope of outsider informed trading. First, we can imagine managers granting informed trading rights as a defensive tactic to ward off a hostile takeover.<sup>187</sup> In such contexts, courts should scrutinize the targeted grant of informed trading rights with higher scrutiny (requiring elevated showing of substantive and procedural fairness) to assure that the grant was likely to further the interest of the traded firm's shareholders. Because of standard concerns about managerial entrenchment, we would also not allow a firm to restrict informed trading by an acquirer. Just as Rule 14e-3 carves out an informed trading exception for acquirers,<sup>188</sup> we would impose a mandatory rule allowing acquirers (to whom Rule 14e-3 presently applies) to trade on the basis of nonpublic information that they were about to launch a tender offer regardless of what limits traded firms place on general informed trading (limited by requirements of the Williams Act and the Hart-Scott-Rodino premerger notification program).<sup>189</sup>

Second, as a general matter, managers may prefer to obscure information about their own poor performance. One of the dimensions along which the Article proposes that traded firms may tailor the right

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trades in return for the large block shareholder's support of managers' control over the firm. This support, in turn, may allow managers to engage in higher levels of self-dealing and other rent-extracting activities from the firm. One of us, nevertheless, has argued that allowing managers to favor shareholders selectively may result in higher aggregate corporate welfare from an ex ante perspective. See Choi & Talley, *supra* note 45.

187. Managers, for example, may deny an acquirer the right to engage in informed trades, requiring the acquirer to disclose any intention of pursuing a tender offer upfront, potentially increasing the price of the target's shares and thereby the cost to the acquirer of engaging in the takeover.

188. See 17 C.F.R. § 240.14e-3(a) (2001) (imposing trading restrictions on "any other person" aside from the "offering person"); 17 C.F.R. § 240.14e-3(c) (2001) (excluding brokers and other agents of the "offering person" from Rule 14e-3's trading restrictions).

189. The Williams Act, an amendment to the Exchange Act, is contained in §§ 13(d)-(e) and 14(d)-(f) of the Exchange Act, 15 U.S.C. §§ 78m(d)-(e) and 78n(d)-(f) and the regulations thereunder, 17 C.F.R. §§ 240.13d-1 to 13e-101, 240.14a-1 to 14f-1 (2002). The Williams Act imposes a variety of regulations on a tender offer including mandatory disclosure and antifraud provisions as well as procedural restrictions. The Williams Act, for example, requires that all shareholders receive "equal treatment." See 17 C.F.R. § 240.14d-10 (2001) (requiring that the "tender offer is open to all security holders of the class of securities subject to the tender offer" and that "the consideration paid to any security holder pursuant to the tender offer is the highest consideration paid to any other security holder during such tender offer").

The Hart-Scott-Rodino Improvements Act of 1976 established a premerger notification program requiring parties to a merger or the acquirer in a tender offer meeting certain size requirements to notify the Antitrust Division of the Department of Justice and the Federal Trade Commission prior to completing the transaction. See § 7A of the Clayton Act (codified at 15 U.S.C. § 18a (2000)); see also William J. Baer, *Reflections on Twenty Years of Merger Enforcement Under the Hart-Scott-Rodino Act*, 65 ANTITRUST L.J. 825 (1997) (assessing the impact of the Hart-Scott-Rodino premerger notification program).

to engage in informed trading is the scope of information.<sup>190</sup> In selecting the scope of allowable information, managers may force the traded firm to restrict outsider trades based on negative information on managerial quality. Regulators, therefore, may wish to impose a blanket limit on the ability of traded firms to block selectively the use of negative manager-related information in trades. Regulators might even want to prohibit traded firms from restricting informed short sales because of the concern that managers may only be restricting short sales to cover up their bad management. But conversely, we do not see how restrictions on long purchases would serve to entrench managers,<sup>191</sup> and such restrictions by traded firms' management should accordingly receive less scrutiny.

Third, because of concerns with the inefficiency of monopoly pricing, we would impose a narrow mandatory rule that prohibited a monopolist (or market dominant) producer from blocking a rival's ability to sell the monopolist's shares short. Richard Hansen and John Lott have shown that giving entrants the ability to sell an incumbent's shares short just before entering the market may facilitate socially beneficial entry.<sup>192</sup>

Moreover, we view these mandatory exceptions to a traded firm's sovereignty over informed trading as being consistent with our broader internalization framework. Managers' self-interest in preserving their jobs in certain specific situations may undermine our confidence in a firm's decision to block the right of outsiders to engage in informed trades.<sup>193</sup> Aside from these narrow contexts, however, outsider trading provides few opportunities for self-interested managers.

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190. See text accompanying notes 272-273.

191. Howell Jackson pointed out to us that managers may wish to curtail all outsider trading to give them more room to profit from insider trading. By disabling the ability of the palace guards just outside the firm to compete for informed trading profits, inside managers could potentially make more money. But we would rely on the current prohibitions on insider trading (or, under a Manne regime, on a substantive scrutiny of the price insiders paid for the trading rights) to handle this inefficiency.

192. See Hansen & Lott, *supra* note 99, at 263-67 (setting forth a model demonstrating that the possibility of an entrant shorting an incumbent's stock prior to entry increases the likelihood of entry when the perceived probability of entry is less than 50%); see also JOHN R. LOTT, JR., ARE PREDATORY COMMITMENTS CREDIBLE?: WHO SHOULD THE COURTS BELIEVE? (1999) (providing historical examples of one company short selling another company's stock).

193. An argument exists, nonetheless, that firms at the time they go public will take into account the possibility of managerial self-dealing and impose limits in the corporate charter restricting the ability of the traded firm to restrict informed outsider trading into the future. See, e.g., Jensen & Meckling, *supra* note 79, at 305-07. But see Gordon, *supra* note 182, at 1573 (arguing that, because drafting a complete corporate contract at the time a company initially goes public is prohibitively expensive, firms will necessarily build in a process for amendments to the corporate charter in the future that may lead to possible opportunistic amendments on the part of managers).

### B. Internalization Proposal

The present securities regime effectively grants all outsider traders a “property” right to engage freely in information research.<sup>194</sup> Excluding inside information and information obtained through a fiduciary breach, an outsider trader is free to make trades based on an information advantage. As discussed above, however, outsider traders individually ignore several effects of their informed trades on other market participants. On the one hand, informed traders may ignore the losses they impose on the other side of the transaction and the higher bid-ask spreads they impose generally on the shareholders of the traded firm.<sup>195</sup> On the other hand, outsider traders may ignore the benefit they provide market participants from the increase in stock price accuracy resulting from their trades (among other impacts). Depending on the particular company, outsider trading may generate either too little or too much information research.

In theory, the traded firm might bribe outsider traders to internalize effects that the traders would otherwise ignore.<sup>196</sup> Although individual outsider traders may ignore the positive and negative effects of their trades on other market participants, the traded firm potentially will take such effects into account. In a world without transaction costs, the traded firm may then contract and negotiate with individual outsider traders to determine the optimal amount of informed trading. Even where the right to engage in informed trades rests with outsider traders, Coase’s theorem provides that the traded firm should be able to pay off the outsider traders.<sup>197</sup> To the extent the cost from the informed trades to the traded firm’s shareholders exceeds the individual benefit to the outsider traders, a value-increasing transaction that in-

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194. See Goshen & Parchomovsky, *supra* note 5 (providing a justification for this property right).

195. See *supra* notes 46-47 and accompanying text (delineating the harmed parties from informed trades).

196. Later, *infra* Section IV.B.2, we will also discuss the possibility that the traded firm could issue restricted shares that would prohibit informed outsider trading and thereby induce outsider traders to bribe the traded firm for the right to engage in informed trading. Traded firms may also attempt to disclose information to reduce the amount of possible information advantage possible through outside research. Not all information relevant to the firm is contained inside the firm, however. Likewise, the traded firm may contract with an outside analyst to engage in information research and then publicize such research freely to reduce the benefits from outside information research. However, even where the traded firm contracts with an outside analyst to provide outside research freely to the market, other outsider traders may still believe (perhaps rightly) that they can research and analyze outside information with more speed and skill than the particular analyst with whom the traded firm contracts.

197. See Coase, *supra* note 31 (setting forth the argument behind the Coase theorem).

ternalizes many of the impacts from information research is possible.<sup>198</sup>

Potential informed traders and the traded firm, however, do not operate in a perfect Coasean world. An extremely large, amorphous and replenishing set of potentially informed traders exists in the market. The very fact that outsider trading often concerns an “erodable” information advantage — that is, an advantage that anyone (or a large class of people) had an equal opportunity to garner *ex ante* through hard work<sup>199</sup> — means that the traded firm would need to negotiate successfully with a vast class of potential outsider traders. Take the situation where outsider traders are honest when asked if they would in fact engage in information research pertaining to the traded firm. The traded firm then faces the severe transaction cost of tracking down and identifying all such outsider traders.<sup>200</sup> Moreover, even if the traded firm succeeded in striking deals with the current class of informed traders, one would expect other investors to emerge to take their place (and reap returns from the informed trading). The class of potential informed traders, while not all-encompassing, might literally run into the thousands.<sup>201</sup>

In the situation where outsider traders may lie about their motives, the traded firm faces even greater obstacles. Even if the traded firm seeks to pay potential informed traders not to engage in information research, it may be unable to distinguish between those outsider traders that would engage in research and those that have no such intention. The traded firm may then face the possibility of paying off an overly large set of potentially informed traders, leading it not to make

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198. Consider Texon again. Imagine that information research will give Helen, an outside investor, an expected trading benefit of \$100 at an expenditure of \$40. Uninformed investors suffer an expected trading loss of \$100. The informed trades, in turn, result in an increase in stock price accuracy benefiting Texon’s shareholders by \$10 and third parties by \$2. The net social loss from information research therefore equals \$28. Helen, however, will take into account only her own net benefit of \$60 from engaging in informed trades. To the extent Texon is able to find and successfully negotiate with Helen, Texon will have the ability to pay Helen not to engage in information research. Texon takes directly into account the \$100 loss to its uninformed investors and the \$10 accuracy benefit, leaving Texon willing to pay up to \$90 to Helen. For any payment above \$60, in fact, Helen will agree not to engage in securities research.

199. See Brudney, *supra* note 15, at 354 (setting forth the unerodable advantages theory of insider trading liability).

200. Carol Rose makes a similar point in noting the difficulty of identifying who owns what entitlements (which she refers to as a “Type I” transaction cost). Rose refers to the costs associated with reaching an agreement once the bargainers and the subject matter are identified as “Type II” transaction costs. See Carol M. Rose, *The Shadow of the Cathedral*, 106 YALE L.J. 2175, 2184 (1997).

201. For example, imagine that there are ten outsider traders who for a research cost of \$40 might each uncover some nonpublic piece of information about Texon that is expected to generate a total trading profit of \$100. Even if such trading harms Texon by \$90 (\$100 trading loss -\$10 increase in stock price accuracy), Texon will have difficulty stretching the \$89 (the most it would be willing to use as bribes) to deter all ten from trading.

such a payment even where information research reduces overall social welfare.<sup>202</sup>

Finally, even if the traded firm succeeds in paying each potential informed trader not to engage in research, it may lack a mechanism to monitor compliance with the “no informed trading” contracts. Any specific trader may trade on information and then simply claim that its higher returns are due to luck rather than any information advantage.<sup>203</sup>

This Article proposes that regulators assist internalization by reassigning the right to control whether informed trading may take place.<sup>204</sup> Rather than allow any trader to decide unilaterally whether to engage in informed trades, regulators should grant only to the traded firm a transferable right to control whether outsiders may engage in informed trades. Pursuant to the newly created right, the traded firm would enjoy the ability to prohibit any party from engaging in informed trades in the traded firm’s securities. Outsider traders would then contract with the traded firm to obtain the right to engage in informed trades. Once connected through contract with outsider traders, the traded firm will then internalize the net benefit to such parties from engaging in informed trades.

Internalization through the traded firm provides further social benefits to the extent multiple potential informed traders may otherwise compete for an information advantage. The traded firm, for example, will internalize the social loss from duplicated information research and wasteful races to obtain an information advantage ahead in time over other investors. Rather than allow multiple investors to engage in such costly duplicative information research, the traded firm may auction off the right to engage in informed trades to a limited number of outsider traders.<sup>205</sup> Where sufficient traders are present in

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202. For example, Helen may consider engaging in information research in Texon at a cost of \$40 to the extent that such research is expected to generate a benefit of \$50. Bruce, on the other hand, may have a cost of \$60 to undertake similar research with an expected payoff of \$50. Where Helen may profit from research, Bruce will not. Bruce nevertheless may represent to Texon that without a payment he will engage in research in order to extract such a payment. Without the ability to distinguish between investors such as Helen and Bruce, Texon may fail to implement a payment program to reduce costly information research.

203. One possible response would be for companies to rely on more procedural devices to constrain informed trading, such as the delayed-trading rule we propound in Section IV.B.3.

204. Admittedly, the Article’s proposal works a radical shift to the present securities regulatory regime. Congressional legislation would likely be needed to put the proposal into effect.

205. Any one company, nevertheless, may find it costly to inform investors about the auction and to run the auction itself. Regulators may therefore set up a centralized system to obtain information on auctions and to conduct the auctions. Some companies may also wish to bundle with other companies the right to engage in informed trades. Particularly smaller companies seeking to auction the right to engage in informed trades may fail to at-



the market, the winning bid will approximate the bidder's expected profit from information research. The auction therefore limits the number of parties engaged in information research, reducing duplicative information expenditures. Because the traded firm receives payments for the right to engage in informed trades, the traded firm then internalizes the net benefit to traders of engaging in such trades.<sup>206</sup>

But we are quite agnostic about the types of informed trading regimes that trading firms may ultimately adopt.<sup>207</sup> Some might prohibit informed outsider trading altogether; others may restrict trading of certain types of information similar to Rule 14e-3's prohibition on trades related to a tender offer; others might sell informed outsider trading rights to a limited set of traders;<sup>208</sup> still others might maintain the current *laissez faire* regime under which outsiders may freely engage in trades subject to the limits imposed through the misappropriation theory, Rule 14e-3, and Regulation FD.

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tract the attention of any one investor. Bundling together with several smaller companies may then generate greater interest among investors. Regulators may assist the bundling process through the establishment of clearinghouses where companies may negotiate with other companies to bundle their trading rights.

An auction for informed trading rights will have some aspects of a common value auction as different potential traders will bid for trading rights the value of which will be conditional on obtaining material nonpublic information related to the traded firm. To the extent different potential traders have the same expectation as to the value of the material, nonpublic information they will uncover, they will each expect a similar trading profit. There are also likely some private value aspects, as different traders are likely to have different costs of acquiring information. The value of "winning" the auction, therefore, will vary across traders. For an extended discussion of the difference between common and private value auctions, see Peter Cramton & Alan Schwartz, *Using Auction Theory to Inform Takeover Regulation*, 7 J.L. ECON. & ORG. 27 (1991). It is often efficient in common value auctions with fixed costs of participation to restrict the number of bidders. See *id.* And similarly, here it may be efficient for a traded firm to limit the number of firms that may in the end have the ability to engage in informed trading.

206. One consequence of this internalization is that firms will then balance the benefit to outside analysts from engaging in information research and informed trading in determining whether or not allowing insider trading is valuable. Haddock and Macey, for example, make the argument that outside shareholders may prefer to allow insider trading because such trading will reduce the amount of other compensation insiders may demand. See Haddock & Macey, *supra* note 96, at 1463. In comparison, when insider trading is prohibited, to the extent non-shareholder investment analysts are the next-best market participant at utilizing firm-specific information advantages, the outside shareholders remain at an information disadvantage and, in addition, must compensate managers more for their lost insider trading profits. See *id.* Nevertheless, once firms are able to control the ability of investment analysts to engage in informed trades, outside shareholders then benefit to the extent of the investment analyst's expected profits from such trades. In such a situation, a firm may very well choose to ban insider trading to increase the profit potential to outside investment analysts, and thereby the amount the firm may receive at auction from analysts seeking the right to engage in informed trades.

207. We discuss various ways that a traded firm could adopt to control informed outsider trading in its securities *infra* Section IV.B.3.

208. Alternatively, traded firms might even give outside trade rights to particular outsiders as an inducement to produce more stock analysts to follow their firms.

But the core idea is to shift the outsider trading right to the party where the expected transaction costs to negotiate contracts resulting in internalization are lowest. While it might seem that the transaction costs of Guido and Ronald cutting a deal would be the same whether we gave an initial entitlement to Guido or Ronald, this is not the case.<sup>209</sup> First if you give the entitlement to the person who would have ended up bargaining for it anyway, you can obviate the need to negotiate at all. Second, the costs of identifying the person with whom one needs to bargain can vary with the law's assignment of the initial property right. Third, the costs of negotiation can be lower if the property right is concentrated in a single bargainer instead of being dispersed among a large class of dispersed owners. Thus, for example, it is easier to solve over-fishing problems if one person controls the fishing rights, rather than if hundreds of people have an equal right to fish.<sup>210</sup>

In the informed trading context, the traded firm serves as a central focal point for market participants to negotiate for the right to engage in informed trades. Because each individual potential informed trader must self-identify itself to the traded firm to obtain the informed trading property right, the overall identification costs of uncovering the informed traders are minimal. And the concern of a replenishing class of potential investors is eliminated because the traded firm (after potentially granting informed trading to a limited class of outsiders) has the right to prohibit the entire amorphous and replenishing class from engaging in such trading. Finally, reassigning this initial right to the traded firm solves the aforementioned problem of faux outsider traders (who in fact would not find it profitable to invest in researching the traded firm but, who) nonetheless seeking a bribe from the traded firm to refrain from informed trading. Because potential informed traders might now pay for the right to engage in such trades, only informed traders that truly find ownership of such a right valuable will make the payment.

Reassigning the right to the traded firm to control whether informed outsider trading takes place also better comports with equitable notions of just deserts. An outsider trader may have a Lockean

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209. See, e.g., Rose, *supra* note 200, at 2184 (discussing costs of identifying contracting parties and costs of actually negotiating the contract); see also Thomas W. Merrill, *Trespass, Nuisance, and the Costs of Determining Property Rights*, 14 J. LEGAL STUD. 13, 20-26, 45-46 (1985) (arguing that judicial "reasonableness" tests help overcome the high costs of identification and bargaining related to nuisances).

210. Where hundreds hold the right to fish, each will ignore the cost they impose on others from depleting the number of fish in the common pool. See, e.g., Ian Ayres & Eric Talley, *Solomonic Bargaining: Dividing a Legal Entitlement to Facilitate Coasean Trade*, 104 YALE L.J. 1027, 1029 (1995) (noting the conventional wisdom that divided entitlements may lead to inefficient strategic behavior). Ayres and Talley, nevertheless, argue that in certain circumstances, splitting an entitlement may lead to efficient transactions when parties hold private information. See generally *id.*

ownership of the information that she has deliberately acquired but this ownership does not as an equitable matter imply a right to trade in *another* company's stock. It is a traditional move in property to disaggregate the bundle of sticks that might pertain to a particular tangible entitlement.<sup>211</sup> But it is particularly odd that legal scholars have so readily jumped to the conclusion that discovering by one's own hard work a relevant fact about a company's future prospect necessarily entitles one to profit by trading against the less informed.<sup>212</sup> The idea that owning such information entails a right to trade probably is a by-product of our dominant image of stocks trading on an unrestricted basis. But there is no equitable reason why "equities" could not be issued on a restricted basis as restricted shares that limit the ability to buy or sell shares only on the basis of publicly available information.<sup>213</sup> In private contracting, a buyer or a seller is always free to demand a warranty that the other side must disclose any material nonpublic information as a precondition of giving her consent. The seller came close to doing just this in *Laidlaw v. Organ*.<sup>214</sup> Of course, the other side

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211. See Robert C. Ellickson, *Property in Land*, 102 YALE L.J. 1315, 1362-73 (1993) (describing the different standard bundles of land rights).

212. See Alan Strudler, *Moral Complexity in the Law of Nondisclosure*, 45 UCLA L. REV. 337, 375 (1997) (arguing that information one has acquired by the dint of one's labor or through other legitimate means is information which one has a presumptive right to use and which may give one a "deserved advantage" in market transactions); see also MARVIN A. CHIRELSTEIN, *CONCEPTS AND CASE ANALYSIS IN THE LAW OF CONTRACTS* 75 (4th ed. 1998) (arguing that "an individual who spends time and money developing information about the intrinsic value of certain property does not and should not have a legal duty to disclose her findings to the property's present owner"). For general philosophical accounts of the moral principle of desert, see LOCKE, *THE SECOND TREATISE* § 27, in *TWO TREATISES*, *supra* note 20 ("Whatsoever, then, he removes out of the state that nature hath provided and left it in, he hath mixed his labour with, and joined to it something that is his own, and thereby makes it his property."). Locke's labor theory of property, however, was conditioned on his famous proviso ("at least where there is enough, and as good left in common for others"). This proviso has often produced the most difficult problems for Locke's theory. See, e.g., ROBERT NOZICK, *ANARCHY, STATE, AND UTOPIA* (1978). From an ex post perspective, Locke's proviso does not particularly militate for or against giving the trading rights to the outsider vs. the traded firm. Granting the right to control outsider trading to either the outsider or the traded firm leaves "less and not as good" for the other. But from a perspective that is sufficiently ex ante, the proviso cuts in favor of granting control to the traded firm, because the traded firm's effort to create the firm must a priori come before the outsider's efforts in acquiring information about the firm.

See also Bainbridge, *Incorporating State Law*, *supra* note 12, at 1252-57; Bainbridge, *Insider Trading Regulation*, *supra* note 21, at 1605-11 (making the argument for a property rights approach to insider trading prohibitions based on the need to give those that expend effort in creating information the incentive to do so); Pritchard, *supra* note 13, at 51 (noting that "[b]y limiting the misappropriation theory to information obtained in breach of a duty, the common law of agency protects individuals who have gained their information advantage through superior insight or hard work. These efforts are essential to the informational efficiency").

213. For a discussion of the ability of a corporation to issue restricted shares, see *infra* Section IV.B.2.

214. 15 U.S. (2 Wheat.) 178 (1817). For a discussion of *Laidlaw*, see *supra* note 32. Focusing on the *Laidlaw* case, Dean Kronman has argued that parties that purposefully ac-

HeinOnline -- 101 Mich. L. Rev. 375 2002-2003

may refuse. But the point is that having nonpublic information about a valuable trading opportunity does not mean as an equitable or legal matter that you will have a right to trade on it without prior disclosure. The source of the information may have worked hard to obtain the information, but other people worked hard to create the firm and have an equitable, Lockean right to control the terms on which its shareholders trade.

Some commentators have argued that as a categorical matter it is unfair for an uninformed buyer or seller to be exposed to the possibility of trading with a superiorly informed counterpart with an “unerodable” advantage.<sup>215</sup> They might contend, for example, that the possibility of facing such an informed trader would undermine the confidence of investors in the market.<sup>216</sup> We disagree. As long as uninformed traders are put on notice that a particular firm has consented to particular types of informed trading, they can protect themselves by trading only on firms’ stock in which informed trading is prohibited. If sufficient numbers of investors care about an equal informational playing field, they could even organize entire stock markets that require listed firms to prohibit informed trading.<sup>217</sup> We, however, imagine that most traders would be willing to accept, say, a 10% chance that they would face an informed trader when they buy or sell in return for the higher dividends that would accrue due to the fees that outsider traders are likely to pay for their privileged right to trade.

And even if one (counter to the foregoing argument) rejected the utility of allowing firms to grant informed trading rights to a limited number of outsiders, then a variant of our proposal should still be attractive. Remember that the current law openly countenances informed trading by outsiders. People who favor equality at all costs should at the very least want to allow traded firms to prohibit broader classes of outside informed trading. Currently Rule 14e-3 imposes a mandatory prohibition on all outsider traders not to trade based on nonpublic tender offer information.<sup>218</sup> But there is little reason to stop traded firms from broadening the class of information subject to Rule 14e-3’s no-trade rule to encompass other types of private information (say, relating to the existence of nonpublic patents or “bet the firm”

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quire an information advantage should enjoy a nondisclosure rule. The nondisclosure rule gives such parties the *ex ante* incentive to research and uncover new information. See Kronman, *supra* note 12, at 12-18.

215. See Brudney, *supra* note 15, at 354-55.

216. See *id.*

217. Alternatively, the existing securities exchanges may make the absence of restrictions on informed outsider trading an explicit listing requirement for shares. See *infra* note 252 (discussing the limits the securities exchanges presently apply to shares with alienability restrictions).

218. See *supra* Section III.B.

litigation). In sum, the idea of reassigning the right to control whether outsiders have an opportunity to engage in informed trading can be tailored to further both efficiency and a variety of conceptions of equity and deserts.

It might strike some that our proposal is more “regulatory” than the current “laissez faire” regime. It is important, however, to emphasize that we are only reassigning to the traded firm the right to control whether outsiders *trade* on the basis of nonpublic information. We are not granting the traded firm any right to control whether outsiders acquire nonpublic information or employ it for other purposes (including disclosing directly to the market). Directly monitoring and specifying the research activities of myriad market parties require tremendous resources. Moreover, information research often generates information relevant to the valuation of more than one company’s securities. Allowing one company to control information research related to the company may adversely affect other companies as a result. Fortunately, such a level of control over individual securities market participants is not necessary for the Article’s proposal. Rather, the traded firm only needs control over the trading activity of its investors.

Our proposal relies just as much on the market to determine the level of information trading as today’s laissez faire system. Unlike today’s laissez faire system, however, the Article’s proposal places the right to engage in informed trades squarely with the party that minimizes the search and contracting costs for all market participants seeking to transact in the informed trading right. The current system might require the traded firm to bribe the potential trader not to trade; in contrast, our regime requires the trader to bribe the traded firm for the right to trade. As a theoretical matter, our proposal is equally consistent with contractual freedom and autonomy, and as a practical matter, likely to be even more consistent as there is likely to be a greater capacity for Coasean dealmaking.

But while we have shown the superiority of giving the traded firms an alienable right to control the extent of informed outsider trading, we have left a host of issues unanswered. Chiefly, we have not addressed what should be the default meaning of a traded firm’s silence. It is also necessary to say more about how a traded firm could opt into an alternative outsider trading regime. The next sections address these issues. We argue that regulators can and should assist in providing a mechanism for traded companies to transact with potential informed traders to transfer the right to engage in informed trades.

### 1. *Choosing the Right Default*

The most basic question is whether a traded firm’s silence should be taken as indicating that it does or does not consent to informed

outsider trading. Of course, if Bernie Black's triviality thesis holds, then the default choice will not matter because traded firms will almost costlessly opt for whatever trading regime they desire regardless of the initial state-imposed default.<sup>219</sup> In this context, at least, we are skeptical of any strong form triviality complaint and instead think that there is likely to be some inertia — by which we mean that we are likely to see more consent in equilibrium — if consent (rather than some form of nonconsent) is the default.<sup>220</sup> Default choice is likely to be nontrivial in the straightforward sense that different defaults are likely to give rise to different contracting equilibria.

We do not see much of a justification for “penalty” (also known as “information forcing”) defaults that penalize a contractor in order to induce express contracting that may signal information about the contractor type or the law.<sup>221</sup> Because we will ultimately require all firms to disclose publicly any attempts at contracting around the default, outsiders will be able to infer a company's informed trading rules by their silence or by their affirmative statements to the contrary. Similarly, we would shy away from adopting “minoritarian” defaults, which set the default at what only a minority of firms would want, because those firms would incur high costs of contracting around or higher costs of failing to contract around an alternative default.<sup>222</sup>

Accordingly we are searching for a “majoritarian” rule as the presumptively most efficient default. If there is likely to be inertia in the shadow of alternative defaults, better to have the inertia around a default rule for which a majority of traded firms would ideally contract. An ahistorical application of our internalization framework would suggest that some form of nonconsent default would be an attractive majoritarian candidate. Remember that laissez faire outsider trading is likely to expose the shareholders of traded firms to uncompensated trading losses, higher bid-asks spreads as transaction costs and the possibility that trading of informed outsiders will effectively leak to the market sensitive proprietary information that the traded firm would rather keep nonpublic. We find it highly unlikely that the benefits of increases in stock price accuracy would outweigh these costs. If

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219. See Bernard S. Black, *Is Corporate Law Trivial?: A Political and Economic Analysis*, 84 Nw. U. L. REV. 542 (1990) (arguing that the choice of many corporate defaults is “trivial” in the sense of not affecting the equilibrium governance of firms).

220. See Ian Ayres & Robert Gertner, *Majoritarian vs. Minoritarian Defaults*, 51 STAN. L. REV. 1591, 1599-1600 (1999) [hereinafter Ayres & Gertner, *Majoritarian vs. Minoritarian Defaults*] (discussing the possibility of inertia where consent is the default).

221. For a discussion of the use of penalty defaults, see Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 YALE L.J. 87, 91-93 (1989).

222. See Ayres & Gertner, *Majoritarian vs. Minoritarian Defaults*, *supra* note 220, at 1593-1606 (discussing a host of non-information forcing reasons why minoritarian defaults might be more efficient than majoritarian defaults).

nothing else, many traded firms would want to limit informed trading so that they had the opportunity of being able to negotiate to be compensated for some of their costs with part of the outsider trading profits.

However, it is extremely difficult to assess exactly what type of restriction on outsider informed trading would be favored by a majority of traded firms. An absolute and all encompassing prohibition against every conceivable type of informed outsider trading (including superior business acumen) would itself impose devastating costs on the shareholders of the traded firm in the form of reduced liquidity.<sup>223</sup> Indeed, there might be no single majoritarian rule. Some firms might want to expand the current Rule 14e-3's prohibition on trading based on nonpublic material information during a tender offer to other classes of confidential information. Others might want to restrict trading based on the identity of specific outsider traders. One method of doing so would be to require all other buyers and sellers of large blocks to announce their intent to transact and to delay trading for a short period. We are especially attracted to this delayed-trading rule (which we will discuss in more detail below) in part because it is a more enforceable procedural restriction.<sup>224</sup> If we were forced to pick a "plurality" default rule guided by theory alone, we would favor some kind of delayed-trading rule — which would force outsiders who want to potentially engage in large-volume trades to bargain for the traded firm's consent to non-delayed (and therefore more secret) trading.

But we are not limited to theory alone. Experience leads us instead to propose retaining the current outsider trading rules as defaults. This would mean that in the absence of words by the traded firm to the contrary (which, as discussed below, would be publicly disclosed in a traded firm's annual Form 10-K filing with the SEC) outsiders would have an absolute right to trade the securities of the traded firm constrained only by the possibility of (1) a misappropriation fiduciary duty to the source of the information; (2) a Rule 14e-3 duty not to trade on tender offer information regardless of fiduciary duty; and (3) a Regulation FD duty on firms not to disclose nonpublic, material information selectively.

We adopt the current outsider trading rules as defaults for a number of reasons. First, and foremost, we are risk-averse. We predict that many traded firms would beneficially modify these defaults to restrict additional forms of outsider trading (at least as a precursor to com-

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223. See Jonathan R. Macey & Hideki Kanda, *The Stock Exchange as a Firm: The Emergence of Close Substitutes for the New York and Tokyo Stock Exchanges*, 75 CORNELL L. REV. 1007, 1012-14 (1990) (noting that increased liquidity reduces the transaction costs associated with holding shares and the information costs facing market participants).

224. See *infra* Section IV.B.3 (discussing the Article's proposed delayed-trading rule alternative).

pensated consent). But we worry that if policy makers were to impose trading restrictions that went too far (and if the traded firms failed to respond quickly to relax these restrictions), the shareholders of the traded firms would bear unacceptable losses in liquidity. Instead of an ahistorical default choice, we favor changing the status quo to a default for the simple reasons that we know that the status quo rules have proven to be reasonably workable. We prefer to maintain the status quo as a benchmark from which individual firms by consenting to alterations can move forward.

Second, we are agnostic about how firms would restrain informed outsider trading (in the absence of explicit contracts with the outsider traders). Instead of funneling firms through a particular constraint, we will discuss below a menu system that facilitates firms' choices among a variety of different types of substantive and procedural trading restraints. Finally, maintaining the current outsider trading rules as defaults (which the traded firm can contract around) is arguably most consistent with current law: as we will discuss in the next section, traded firms might already be able to contract effectively for more control of informed outsider trading by issuing various types of restricted stocks.

We should also say a word about our choice to retain the three restrictions on outsider trading (pertaining to misappropriation, Rule 14e-3 and Regulation FD) as default restrictions. Our proposal would still give outside sources the opportunity to contract with their agents against misappropriation. But in addition to this misappropriation restriction, an agent would have to see whether the traded firm permitted this type of informed trading.<sup>225</sup>

For us, retaining the tender offer and selective firm disclosure restrictions (of Rule 14e-3 and Regulation FD) presents a much closer case. As a historical matter, the market worked reasonably well both with and without these rules. Thus, risk aversion about worst case scenarios need not play as an important role in our analysis. Because most firms involved in a takeover would want to prohibit uncompensated informed trading by outsiders (and might otherwise expend excessive resources to maintain secrecy about such information), we are comfortable with retaining the Rule 14e-3 restriction as at least a default rule, requiring both the acquirer's and the target's consent to waive. We would also make the Regulation FD restriction on selective disclosures a default rule, allowing a disclosing firm to waive the restriction if it publicly discloses *ex ante* in its quarterly Form 10-Q report to the SEC that it might make a particular type of selective disclosure. In sum, our proposal would change the current system into a

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225. For example, under the Article's proposal, if the traded firm opted not to allow any informed outside trades then the agent would lack the ability to engage in such trades even with the complete knowledge and approval of the source.



regime of default trading restrictions (regarding tender offer, misappropriated and selectively disclosed information) and default trading permissions (with regard to all other informed outsider trading) around either of which the traded firm would be allowed to contract unilaterally to increase or decrease the types of permitted informed trade.<sup>226</sup>

## 2. *Current Opportunities for Traded Firms to Control Informed Trading*

Before moving on to discuss how regulators might facilitate the traded firms' ability to opt for broader or narrower trading restrictions, it is important to pause briefly to consider whether firms could move privately to restrict the current outsider trading that is countenanced by U.S. securities regulation. Earlier we said that current law effectively assigned to the outsider source the right to control unilaterally whether informed outsider trading takes place. However, there are ways that the traded firm already might dampen the opportunity for such outsider trading.

One way for a traded firm to accomplish this is to disclose non-public information more quickly to the market.<sup>227</sup> There is some evidence that firms have pursued this strategy, disclosing sales data and other corporate performance data through general conference calls and other forms of public disclosures on shorter periodic bases.<sup>228</sup> But there are two limits to this strategy. First, early disclosure to the market is at times inimical to the firm's other goals. Think *SEC v. Texas Gulf Sulphur*.<sup>229</sup> Disclosing that Texas Gulf Sulphur had discovered a rich copper field in Canada would have preempted informed trading in the company's securities, but would have made it harder to buy

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226. We can imagine a possible exception to this pure default system of traded firm control. We might want to impose a narrow mandatory rule that prohibited monopolist (or market dominant) producers from blocking a rival's ability to sell their shares short. See text accompanying note 192.

227. Cf. Ian Ayres, *Back to Basics: Regulating How Corporations Speak to the Market*, 77 VA. L. REV. 945, 995 (1991) (noting that firms may prefer to engage in broad based disclosures to preempt the ability of both insiders and outsiders to profit from an information advantage).

228. See Jonathan Fuerbringer, *When Companies Talk, Who Gets to Listen?*, N.Y. TIMES, Oct. 20, 2000, at C1 (noting that "broadcasting of Wall Street analysts' meeting on the Internet, what is known as Webcasting, is already becoming standard procedure and will grow, as will public access to conference calls that companies use to brief analysts"). Fuerbringer reports that the National Investor Relations Institute estimated that "86% of its member companies that hold earning conference calls allowed individual investors to listen in, up from 29% two years ago. About 74% let the news media listen in, up from 14%." *Id.*

229. 401 F.2d 833 (2d Cir. 1968).

land surrounding the field on the cheap.<sup>230</sup> Second, the traded firms themselves may not know the information on which the informed outsiders are trading. A rival who knows it has just won or lost a patent race or an analyst who knows about a likely regulatory change may have material nonpublic information which the traded firm itself could not disclose even if it wanted to.

A more direct way for a traded firm to impose legal restrictions on informed outsider trading is by issuing restricted stock.<sup>231</sup> Today, closely held corporations routinely make use of restrictions on the ability of their shareholders to transfer their shares. The most common forms of restrictions are rights granting the corporation or one of its shareholders the right of first refusal on the purchase of a selling shareholder's shares.<sup>232</sup> Corporations have limited the ability of shareholders to sell shares to others outside the group of current shareholders and imposed requirements that shares must be sold back to the corporation after the death of a shareholder.<sup>233</sup> Corporations may also use transfer restrictions to limit the fraction of shares that any person or group of persons may own.<sup>234</sup> Even public corporations have placed restrictions on shares sold to employees allowing the corporation to repurchase the shares at the end of employment.<sup>235</sup> Public corporations have also placed restrictions on the ability of shareholders to sell to foreign entities that already hold a significant stock ownership.<sup>236</sup> More procedural restrictions exist. Corporations, for example, may require shareholders seeking to transfer their shares to obtain the consent of the corporation or of a particular shareholder.<sup>237</sup>

230. The *Texas Gulf Sulphur* case involved the timing of the release of information involving the discovery of a major copper and zinc ore strike in Canada. *See id.* at 845-46.

231. Corporations generally may impose restrictions on the transferability of their own stock in the corporate charter or by-laws. Delaware's General Corporation Law, for example, provides corporations the ability to place restrictions on the transferability of shares to the extent certain prerequisites are met. DEL. CODE ANN. tit. 8, § 202 (2001). Among other requirements, restrictions must be written and "noted conspicuously" on the stock certificate. *Id.* § 202(a). Restrictions must also be imposed either through the certificate of incorporation, the corporate bylaws, or through an agreement among any number of security holders and the corporation. *Id.* § 202(b). Section 8-204 of the Uniform Commercial Code also provides that a transfer restriction will only be effective against shareholders with actual knowledge of the restriction unless the restriction is conspicuously noted on the security. U.C.C. § 8-204 (1999); *see also* DEL. CODE ANN. tit. 8, § 202(a) (2000).

232. § 202(c)(1) of the Delaware Code expressly permits the creation of first refusal right restrictions. DEL. CODE ANN. tit. 8, § 202(c)(1) (2000).

233. *See, e.g.,* R. FRANKLIN BALOTTI & JESSE A. FINKELSTEIN, 1 THE DELAWARE LAW OF CORPORATIONS AND BUSINESS § 6.6 (3d ed., 2001 Supp.).

234. DEL. CODE ANN. tit. 8, § 202(c)(5) (2000) (requiring that such a restriction not be "manifestly unreasonable").

235. *See* BALOTTI & FINKELSTEIN, *supra* note 233, § 6.6.

236. *See id.*

237. Delaware Section 202(c)(3) permits consent restrictions on share transferability. *See* DEL. CODE ANN. tit. 8, § 202(c)(3) (2000).

And legal restrictions on trading can be imposed on buyers — with whom a firm is not previously in privity — as well as sellers. Just like property covenants that run with the land,<sup>238</sup> a trading restriction runs with the stock.<sup>239</sup> Traders purchase the stock subject to the restriction, thereby effectively accepting the traded firm's offer to restrict trading (just as they consent to other governance issues).

Given the broad range of allowable substantive and procedural stock restrictions, corporations may already possess the ability to issue stock restricting the ability of outsiders to engage in informed trading.<sup>240</sup> Most dramatically, a corporation could issue stock requiring that as a condition of buying or selling shares that a trader publicly disclose any material nonpublic information concerning the company. Alternatively, as discussed more fully below, the stock could require that large-volume traders delay trading until after they had adequately disclosed their intent of buying or selling large volumes.<sup>241</sup>

Legal restrictions exist, nevertheless, on the ability of a corporation to impose alienability restrictions on their own stock. Courts have struck down absolute limits on alienability.<sup>242</sup> In Delaware, courts have required that, despite the presence of Section 202's express provision for stock transfer restrictions, the restrictions must be "reasonable."<sup>243</sup> Even where legally valid, corporations employing a restriction on

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238. For a discussion of property covenants that run with the land, see JESSE DUKEMINIER & JAMES E. KRIER, *PROPERTY* 855-949 (3d ed. 1993).

239. Delaware, for example, provides that a transfer restriction valid under Section 202 of Delaware's General Corporate Law is enforceable not only against the holder of the restricted security but also against "any successor or transferee of the holder including an executor, administrator, trustee, guardian or other fiduciary entrusted with like responsibility for the person or estate of the holder." DEL. CODE ANN. tit. 8, § 202(a) (2000).

240. Significantly, the list of permissible restrictions on the transferability of stock contained in Del. Section 202(c) is nonexclusive. DEL. CODE ANN. tit. 8, § 202(e) (2000) (providing that "any other lawful restriction on transfer or registration of transfer of securities, or on the amount of securities that may be owned by any person or group of persons, is permitted by this section").

241. See text accompanying notes 282-303 (discussing the Article's proposal to allow traded firms to impose trading delays on outside investors).

242. See *Allen v. Biltmore Tissue Corp.*, 141 N.E. 2d 812, 816 (N.Y. 1957) (declaring that a right of first refusal agreement that made it effectively impossible to sell to anyone but the corporation at a price determined by the corporation would be void); *Rychwalski v. Baranowski*, 236 N.W. 131, 132 (Wis. 1931) (stating in dicta that it is "well established in this state that a corporate by-law which prohibits the alienation of shares of stock, or which amounts to an unreasonable restraint upon their transfer, is void").

243. See generally BALOTTI & FINKELSTEIN, *supra* note 233, § 6.11 (noting that the proper purpose requirement comes out of the principle derived in *Lawson v. Household Finance*, 152 A. 723 (Del. 1930), that "a restraint on the free transferability of corporate stock . . . is permissible under our law provided it bears some reasonably necessary relation to the best interests of the corporation.") (quoting *Grynberg v. Burke*, 378 A.2d 139, 134 (Del. Ch. 1977)). Delaware § 202(d) provides a list of purposes presumptively assumed reasonable. Restrictions imposed to maintain any local, state, federal or foreign tax advantage or to maintain or comply with any statutory or regulatory advantage or requirement are included under Section 202(d). See DEL. CODE ANN. tit. 8, § 202(d) (2001).

stock alienability may face large enforcement hurdles. Many investors, for example, do not hold ownership directly. Rather, the investors' brokers typically will hold ownership of the securities in their "street name," allowing for the constant transfer of ownership without the necessity of recording each ownership change in the corporate records.<sup>244</sup> Corporations seeking to enforce an information-based trading restriction on a public shareholder, therefore, must expend considerable resources first identifying the investor.

Even when identified, corporate law may place limits on the types of sanctions companies may impose on investors who violate their restrictions. Corporations may first attempt to stop an unauthorized transfer outright through instructions to the corporation's transfer agent not to register prohibited transfers.<sup>245</sup> Even without registration, however, a purchaser of restricted shares may attempt to make an equitable claim of ownership in the corporate assets.<sup>246</sup> Corporations may also seek to limit the ability of investors who possess shares transferred in violation of a transfer restriction to vote the shares or receive dividends based on the shares. Whether corporations are in fact able to limit the voting power or dividend rights of such shares, however, is uncertain.<sup>247</sup>

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244. See Thomas W. Joo, *Who Watches the Watchers? The Securities Investor Protection Act, Investor Confidence, and the Subsidization of Failure*, 72 S. CAL. L. REV. 1071, 1073 & n.3 (1999) (noting that "stock held in street name can represent as much as 80% of a public company's outstanding shares").

245. See WILLIAM MEADE FLETCHER, 12 FLETCHER CYCLOPEDIA OF PRIVATE CORP. § 5497 (perm. ed., rev. vol. 1996) (noting that the unregistered transferee of stock is not entitled to the rights and privileges of a shareholder).

246. See *id.* (noting that an unregistered transfer still passes equitable title to the transferee who may then sue to establish their right in corporate property). An unregistered transferee of shares is still entitled to all dividends declared after the transfer. Where the corporation has notice of the transfer, the transferee may hold the corporation liable for the dividends; where the corporation is not on notice, the transferee may still seek to obtain the dividends directly from the transferor shareholder. See *id.* § 5499.

247. Existing Delaware case law has allowed corporations to implement "scaled" voting under which maximum limits are placed on the number of votes held by any one shareholder. See *Providence & Worcester Co. v. Baker*, 378 A.2d 121 (Del. 1996). But see BALOTTI & FINKELSTEIN, *supra* note 233, § 6.10 (stating that "vote sterilization provisions are usually limited in application to situations in which the exercise of voting rights would permit alien control of the corporation to a greater extent than permitted by the restriction . . ." and that "[t]he validity of such provisions, however, remains to be adjudicated"). Stock exchanges in the United States also contain express rules against reducing the voting power of existing shareholders. See NASD Manual (CCH), Rule 4351 ("Voting rights of existing shareholders of publicly traded common stock registered under Section 12 of the [Exchange] Act cannot be disparately reduced or restricted through any corporate action or issuance."); 2 Am. Stock Ex. Guide (CCH), § 122 (2000) (same).

Delaware has also long held a strong bias toward allowing only pro rata dividends to shareholders of the same class. DEL. CODE ANN. tit. 8, § 170 (1998); REV. MODEL BUS. CORP. ACT § 6.40 (1998); see 11 FLETCHER CYCLOPEDIA OF PRIVATE CORP. § 5352 (perm. ed., rev. vol. 1995); EDWARD P. WELCH & ANDREW J. TUREZYN, *FOLK ON DELAWARE CORPORATION LAW: FUNDAMENTALS* § 170.2, at 340-41 (Little Brown ed. 1993); see also Edward B. Rock & Michael L. Wachter, *Waiting for the Omelet to Set: Match-Specific Assets*

Shareholder consent may present another barrier to firms seeking to impose transferability restrictions on their stock. Where a stock restriction is adopted in a corporation's initial certificate of incorporation, all shareholders who receive securities are presumed to consent and are thereby bound under the restriction.<sup>248</sup> An entirely different situation exists, however, where a firm attempts to adopt a stock restriction after it has already issued shares. If the restrictions are introduced midstream, they could be effectuated by an amendment to the certificate of incorporation.<sup>249</sup> Even with such an amendment, however, Delaware treats nonconsenting shareholders as not bound under the restriction.<sup>250</sup>

There are, however, several solutions to the problem of nonconsenting shareholders to a midstream imposition of a stock restriction. Public corporations seeking to adopt a stock restriction may form a Delaware-based subsidiary. The subsidiary's certificate of incorporation will provide for the desired stock restriction. The public corporation may then engage in a statutory merger with the subsidiary, extinguishing its own shares and giving each of its shareholders shares of the subsidiary in return.<sup>251</sup> Alternatively, a public corporation may seek to reincorporate into Delaware, employing the stock restrictions in its newly issued Delaware certificate of incorporation.

It must be conceded that to our knowledge, no traded firm has availed itself of stock restrictions as a means to retard informed outsider trading. The absence of such efforts certainly cannot be taken as confirmation of the foregoing internalization framework. Our earlier analysis suggests that at least some firms should want to restrict certain kinds of informed outsider trading, and that others would want to

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and *Minority Oppression in Close Corporations*, 24 J. CORP. L. 913, 921 (1999) ("It would be clearly illegal — and easily challenged — if the majority shareholder paid itself \$1 per share in dividends, while only paying minority shareholders \$.10 per share.").

Balotti and Finkelstein note that corporations may employ automatic sale or transfer provisions to the corporation or some other shareholder to enforce transfer restrictions. See BALOTTI & FINKELSTEIN, *supra* note 233, § 6.10 (noting authority for automatic sale/transfer provisions under Delaware General Corporation Law § 202(c)(4)). Balotti and Finkelstein also note that corporations may employ automatic conversions provisions in the certificate of incorporation, converting stock transferred in violation of a transfer restriction into non-voting and/or non-dividend paying securities. See *id.* § 6.10.

248. See, e.g., *St. Louis Union Trust Co. v. Merrill Lynch, Pierce, Fenner & Smith Inc.*, 562 F.2d 1040 (8th Cir. 1977).

249. Under Delaware law, an amendment to the certificate of incorporation requires consent by a majority of all stock entitled to vote as well as a majority of each class of shares entitled to vote. See DEL. CODE ANN. tit. 8, § 242(b)(1) (2001).

250. *Id.* at § 202(b); see also *B & H Warehouse, Inc. v. Atlas Van Lines, Inc.*, 490 F.2d 818 (5th Cir. 1974); *Joseph E. Seagram & Sons, Inc. v. Conoco Inc.*, 519 F. Supp. 506 (D. Del. 1981).

251. In a statutory merger, under state corporate law, the dissenting shareholders would still enjoy appraisal rights. For a general discussion of appraisal rights, see 12B, 12 FLETCHER CYCLOPEDIA OF PRIVATE CORP. § 5906.10 (perm. ed., rev. vol. 2000).

bargain for compensation for such rights. One way to interpret the traded firms' seemingly ubiquitous acquiescence to outsider trading is to emphasize the importance of liquidity. Trading restrictions of any kind may have such a chilling effect on even uninformed outsider trading that traded firms find that the cost of such restrictions (in terms of lower liquidity) always exceed the benefits outlined above.

But we do not think the current absence of private efforts to restrict outsider trading is strong disconfirming evidence of our theory. An individual firm that wanted to combat the problem of uncompensated informed trading by outsiders would face a variety of legal and non-legal barriers in using restricted stock. Notwithstanding the use of restricted stock in other contexts, there still is some residual uncertainty about whether trading restrictions would be legally enforceable or whether they would violate exchange rules.<sup>252</sup> And there is even more uncertainty whether discriminatory trading restrictions — which

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252. The NASDAQ market, for example, will “exercise broad discretionary authority over the initial and continued inclusion of securities in NASDAQ in order to maintain the quality and public confidence in its market.” NASD Manual (CCH), Rule 4300. Although the NASDAQ’s listing requirements do not formally exclude securities with transfer restrictions, *see id.* Rules 4310, 4420, they do require the presence of a minimum number of registered market makers, among other requirements. Where transfer restrictions greatly reduce liquidity or otherwise make it difficult for market makers to provide simultaneous bid-ask prices for a company’s securities, the traded firm may fail to obtain the interest of sufficient numbers of market makers to meet NASDAQ’s listing requirements.

While the New York Stock Exchange and the American Stock Exchange do not impose explicit prohibitions against restrictions on transferability for the securities of domestic companies, their focus on establishing an “auction market” for trading may lead the two Exchanges to view negatively stock with stringent transferability restrictions. *See* 2 Am. Stock Ex. Guide (CCH) ¶ 10,002 § 102(a) (2000) (“In evaluating the suitability of an issue for listing under this trading provision, the Exchange will review the nature and frequency of such activity and such other factors as it may determine to be relevant in ascertaining whether such issue is suitable for auction market trading.”); 2 N.Y.S.E. Guide (Constitutions and Rules) (CCH) ¶ 2499 (2000) (“The aim of the New York Stock Exchange is to provide the foremost auction market for securities of well-established companies in which there is a broad public interest and ownership.”). In the case of foreign securities, moreover, the American Stock Exchange in assessing whether to list an American Depositary Receipt does explicitly prohibit transfer restrictions on the underlying foreign securities. *See* 2 Am. Stock Ex. Guide (CCH) ¶ 10,010 § 110 (2000) (Securities of Foreign Corporations) (“Underlying shares will not be accepted for deposit or transfer if they are subject to any restrictions on sale or transfer and unless they are accompanied by all certifications required by the United States or the country of origin.”).

Outside the United States, many exchanges refuse to list securities with legends that restrict the transferability of the securities. *See* Comment Letter of Morgan Stanley & Co. Incorporated 2 n. 1, File No. S7-8-97 (June 25, 1997) (noting that “[t]he requirements for listing equity securities on certain Asian, European and Latin American stock exchanges (such as the exchanges in Hong Kong, Singapore, Switzerland, Brazil, and Mexico) preclude leg- ending and other trading restrictions of the type proposed”); *see also* HAROLD S. BLOOMENTHAL & SAMUEL WOLFF, 1 GOING PUBLIC AND THE PUBLIC CORPORATION, § 4A.01 [13B] (2000) (quoting comments by the Toronto Stock Exchange that “[t]he purpose [of the prohibition against securities with transfer restrictions] is to ensure that a purchaser receives a valid security that is readily marketable without restrictions arising from the characteristics of the certificate received. In an impersonal auction market, all purchasers must be assured of receiving a security affording identical rights to those received by others”).

restricted some outsider traders' ability to trade, but which allowed others to trade on an informed basis (in exchange for compensation) — would be legally permissible.<sup>253</sup> There could also be large costs in the market in trying to absorb and “price” information about a traded firm's idiosyncratic outsider trading regime. So while we do not think there are large network externalities in writing these contracts or in having courts interpret them,<sup>254</sup> there may be important externalities in having the market evaluate the costs and benefits of restricting outsiders' ability to trade on particular types of nonpublic information.

Moreover, even if such restrictions were enforceable as a formal matter of civil law, the restrictions might not provide effective deterrence against informed trading if they fail to provide adequate procedures for detecting and punishing violations. The SEC actively investigates and pursues civil remedies for misappropriation and Rule 14e-3 violations.<sup>255</sup> Working through the Justice Department, the SEC may also seek criminal penalties.<sup>256</sup> Indeed, the watershed case of *United States v. O'Hagan*<sup>257</sup> involved the criminal prosecution of James

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253. Such discriminatory trading restrictions run counter to the SEC's own movement toward leveling the playing field for investors under Regulation FD. The SEC has stressed the need to allow trading advantages only when each investor enjoys an equal erodable ability to obtain the information is necessary to preserve investor confidence in the market. See SEC, Selective Disclosure and Insider Trading, *supra* note 5, at 51,716 (to be codified at 17 C.F.R. § 243.100-.103). Once firms actively restrict certain investors from engaging in informed trades, while giving others the ability to do so, investors will no longer each enjoy the same ability to profit from securities research.

254. For a general discussion of network externalities in the area of contracts and corporate law, see Michael Klausner, *Corporations, Corporate Law, and Networks of Contracts*, 81 VA. L. REV. 757, 758 (1995). Cf. Ian Ayres, *Making a Difference: The Contractual Contributions of Easterbrook and Fischel*, 59 U. CHI. L. REV. 1391 (1992) (arguing that muddy defaults may produce network like precedential effects).

255. For example, the SEC obtained civil liability findings and settlements based on Rule 10b-5 and Rule 14e-3 against several individuals alleged to have traded based on material, nonpublic information related to several AT&T acquisitions from 1988 to 1991. See *Insider Trading: SEC Notes Additional Rulings in AT&T Insider Trading Ring Case*, BNA SECURITIES LAW DAILY, Feb. 3, 1999, available at LEXIS, BNA, INC., SECURITIES REGULATION AND LAW REPORT, Feb. 5, 1999, Vol. 31, No. 5, 171. The SEC, moreover, may pursue enforcement for violations of Regulation FD. To alleviate concerns that too stringent enforcement of Regulation FD may chill information disclosure to the market, the SEC stated that it would seek enforcement only where the “issuer's personnel knows or is reckless in not knowing that the information selectively disclosed is both material and non-public.” SEC, Selective Disclosure and Insider Trading, *supra* note 5, at 51,718; see also Michael Schroeder, *Raytheon's Disclosure to Analysts Is Investigated*, WALL ST. J., Mar. 15, 2001, at A3 (reporting that the SEC's investigation of Raytheon Corp. for violation of Regulation FD represents “the first test of the controversial SEC rule”).

256. The SEC may refer willful violations of the securities laws to the Department of Justice for criminal prosecution. Securities Act of 1933, 15 U.S.C.A. § 77z (1996); Securities Exchange Act of 1934, 15 U.S.C.A. § 78ff (1997) (providing for up to ten years in prison for the willful violation of any Exchange Act provision or SEC rule or regulation under the Act). In 1996, SEC referrals resulted in fifty-seven criminal convictions. See SECURITIES AND EXCHANGE COMMISSION, 1996 ANNUAL REPORT 2 (1997).

257. 521 U.S. 642 (1997).

O'Hagan based on both the misappropriation theory under Rule 10b-5 as well as for violation of Rule 14e-3.<sup>258</sup> But under current law, there is no way for a traded firm to enlarge unilaterally the scope of the SEC's enforcement authority with regard to informed outsider traders who have no contractual relationship with the traded firm.<sup>259</sup> By manipulating the misappropriation doctrine, traded firms can contract with parties that owe a fiduciary duty not to trade based on information derived from the traded firms, thus empowering the SEC to investigate and criminally punish violations.<sup>260</sup> But traded firms cannot currently use public law to stop stock analysts or industry participants not in a fiduciary relationship with the firm (e.g., rivals, complementary producers, etc.) from engaging in informed trading in the absence of contract with the potential outsider trader.

Finally, and perhaps most importantly, even where traded firms are able to restrict informed trades on the part of investors who purchase securities directly issued by the traded firms, many outsider traders may profitably engage in information research through trades in the options and futures markets. Anyone may create and sell options based on a traded firm's securities.<sup>261</sup> An informed outsider trader may then trade the options in the secondary market, avoiding the need to directly trade in the traded firm's securities. A firm's restricting informed trades in the common stock of a traded firm, therefore, may simply result in a shift in transactions to options and futures, resulting in just as much informed trading. Traded firms cannot currently restrict the private derivative trades of others, but government regulation could easily restrict informed trading on derivative contracts. And such regulation could delegate to the traded firms control over the scope of such restrictions.<sup>262</sup> The government therefore has a

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258. In *O'Hagan*, the Supreme Court expressly upheld that criminal liability under § 10(b) may be based on the misappropriation theory of insider trading. *See id.* at 650.

259. For a discussion on the value of allowing private parties to contract for government provided enforcement, see Stephen Choi, *Market Lessons for Gatekeepers*, 92 NW. U. L. REV. 916, 951-58 (1998).

260. *See supra* note 14 (discussing Merrill Lynch's decision to bar its analysts from purchasing securities which they cover).

261. A call option, for example, allows the owner of the option the right to buy an underlying stock at a specific exercise price. For a description of options, see RICHARD A. BREALEY & STEWART C. MYERS, *PRINCIPLES OF CORPORATE FINANCE* 483-504 (4th ed. 1991).

262. Traded firms also have difficulty restricting offshore trading based on nonpublic information. But the SEC has jurisdiction over all shares issued in the United States and could require that shareholders submit themselves to U.S. jurisdiction as a precondition of receiving dividends. The pragmatic problems of enforcing restrictions on informed trading in offshore markets are therefore no greater with regard to outsider trading than with regard to the current insider trading restriction — where notwithstanding the presence of offshore trading markets for some of the larger issues (such as Enron), the restrictions seem to have some bite.



useful role to play in facilitating a traded firm's control over the level of informed outsider trading related to the firm. And it is this topic to which we now turn.

### 3. Tailoring the Opt Out Menu of Trading Restrictions

The government can facilitate the traded firms' ability to contract to internalize the full costs and benefits of informed outsider trading by clarifying what is sufficient to create enforceable trading restrictions. By establishing clear "opt out" rules (that is, rules which allow firms to opt out of the current laissez faire outsider trading regulations) and by providing firms with a plausible menu of off-the-rack restrictions from which to choose, government can send a clear message that both traded firm-imposed restrictions on informed trading and sales of informed trading privileges are allowed.<sup>263</sup>

First, we propose the following opt out procedures. In order to opt out (1) both a majority of a firm's board and a majority of a firm's shareholders would have to approve an alteration in the current outsider trading regulations and (2) the alteration would need to be publicly disclosed in its annual Form 10-K filing with the SEC.<sup>264</sup> The majority approval requirements are traditional indicia of consent of the affected parties.<sup>265</sup> But the mandatory disclosure requirement requires a bit more justification. We believe that market participants should be put on notice about the type of firm with which they are trading. Especially if a traded firm is going to create a less than level-playing field, it should be under a legal obligation to inform the market to proceed at its own risk. There is, however, still a question of how much notice is sufficient. At a minimum, if they aim to prohibit or restrict larger classes of informed outsider trading, firms need to give notice to potential traders about the extent of the trading restrictions. Investors unable to distinguish between firms that allow informed trading and those that do not may fail to price accurately the securities of both types of firms.<sup>266</sup> Regulators may usefully assist potential in-

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263. One reason for establishing a menu system of limited choice is to economize on the markets costs of processing information. A traded firm may not fully internalize the costs that it creates for market participants by including idiosyncratic restrictions on its forms.

264. See 17 C.F.R. § 249.310 (2002) (Form 10-K).

265. For example, under Delaware's General Corporation Law a majority of the voting stock of the nonsurviving corporation in a merger must approve the merger. DEL. CODE ANN. tit. 8, § 251 (2000) (requiring a vote by a majority of the stock entitled to vote to approve a statutory merger).

266. In the context of insider trading prohibitions, for example, Bainbridge argues that a voluntary system of insider trading regulation may suffer from a lemon's problem. See Bainbridge, *Insider Trading Regulation*, *supra* note 21, at 1625-26. Assume that investors value insider trading prohibitions. Some firms may adopt an insider trading prohibition and enforce such prohibitions. Other firms may choose either to not adopt prohibitions or, if

formed traders by establishing a centralized public database to disseminate information on each company's policy with respect to informed trading.<sup>267</sup> Summarizing the informed trading rules of different companies will be particularly easy if firms opt for the off-the-rack menu items discussed below.

But we would go further and require traded firms to also disclose information about which traders have the traded firm's consent to violate the trading restrictions that apply to the public in general. It should not be enough for a firm to say "We reserve the right to grant informed trading rights to certain unnamed traders in contravention of the foregoing restrictions." We would require the trading firm that was creating unequal outside trade rights *ex ante* to disclose expressly the identities of favored outsiders so that uninformed traders can more fully assess whether they want to play on this particular type of uneven field.

As previously argued, we would ideally allow firms either to expand or contract the ability of outsiders to engage in informed trading. Thus, we would allow traded firms to reduce the prohibitory scope of Rule 14e-3 or Regulation FD to permit more informed outsider trading. But even if we maintained the mandatory nature of these rules, there would still be a strong internalization rationale to give traded firms the option of going beyond the present scope of Rule 14e-3 to restrict the ability of outsiders to engage in informed trading based on even non-tender offer-related classes of information.

We feel more strongly about preserving a traded firm's option of constraining the ability of outsiders to engage in informed trades. Granting informed trading rights to a few outsider traders can economize on social research costs and compensate a traded firm's shareholders for their informed trading losses. Without such compensation, traded firms may find it individually rational to inefficiently rush to disclose information to preempt uncompensated trading losses. But even if (inspired by the ambition behind Regulation FD) we prohibited traded firms from consenting to outsider favoritism, there would remain a strong internalization rationale for giving traded firms the option of instituting across-the-board informed trading restrictions that go further than our current regulations. Indeed, the impulse for mandatory, level informational playing fields certainly militates in favor of granting traded firms the option of prohibiting a broader class of information advantage. Accordingly, for the rest of

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they do adopt prohibitions, not enforce the prohibitions. To the extent investors are unable to distinguish among such firms, they will not give the firm that both adopts and enforces insider trading prohibitions a price premium, reducing the incentive of firms to ban insider trading. *See id.*

267. The SEC already provides investors easy access to public securities filings of corporations contained with the EDGAR database at <http://www.sec.gov/edgar.shtml>.

this section, we will focus on traded firms wishing to institute more far-reaching restrictions on informed trading that could not be bargained away by particular traders.<sup>268</sup>

The government might be able to assist traded firms in internalizing the impacts of informed outsider trading by giving them a menu of alternative regimes. While this menu might also allow traded firms to craft idiosyncratic outsider trading regulations, it is useful to think about two different dimensions on which the choices might be arrayed: (i) the scope of allowable informed trading and (ii) the mechanism to enforce restrictions on informed trading.

As to the scope of nonpublic information that give rise to a trading restriction, we could imagine a menu that permitted firms to restrict trades on the basis of all "material, nonpublic" information. Under this standard, an outsider trader could not trade on the basis of any information to which the insider trading ban would apply. It is useful to remember that this is just the standard that the SEC unsuccessfully pushed for in *United States v. Chiarella*.<sup>269</sup> But given the notorious uncertainties in distinguishing material from non-material information,<sup>270</sup> such a standard is likely either to reach underinclusively, allowing substantial amounts of profitable informed trading,<sup>271</sup> or to sweep over-

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268. Some companies may wish to auction the right to engage in informed trades. See *supra* notes 205-206 and accompanying text.

269. The Second Circuit agreed with the SEC in *United States v. Chiarella*, 588 F.2d 1358, 1362 (2d Cir. 1978), *rev'd* 445 U.S. 222 (1980) (holding that the federal securities laws have "created a system providing equal access to the information necessary for reasoned and intelligent investment decisions"). The Second Circuit had earlier espoused a similar view in *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 848 (2d Cir. 1968) (stating "[t]hus, anyone in possession of material inside information must either disclose it to the investing public or . . . must abstain from trading in or recommending the securities concerned while such inside information remains undisclosed"). The Supreme Court, however, rejected the SEC and Second Circuit's parity-of-information view in *Chiarella v. United States*, 445 U.S. at 235 (holding that "a duty to disclose under § 10(b) does not arise from the mere possession of nonpublic market information"). See also *Dirks v. SEC*, 463 U.S. 646, 657 (1983) (rejecting the SEC's position that the antifraud provisions of the securities laws require equal information among all traders).

270. The Supreme Court in *Basic, Inc. v. Levinson*, 485 U.S. 224 (1988), held that a fact is material under Rule 10b-5 if "there is a substantial likelihood that a reasonable shareholder would consider it important." *Id.* at 231 (quoting *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976) (determining the standard of materiality for an action under Rule 14a-9 of the Exchange Act)). The Court also held that "to fulfill the materiality requirement 'there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the "total mix" of information made available.'" *Id.* at 231-32 (quoting *TSC Industries*, 426 U.S. at 449).

271. Marcel Kahan, for example, distinguishes between an information advantage that derives from "factual" information and advantages that derive from "assessment" of the factual information on the part of a specific investor. See Kahan, *supra* note 56, at 990. Kahan recognizes that the two forms of advantages are similar in that once a sufficient number of investors possess the information, it will be incorporated into the market price. See *id.* Nevertheless, he makes that argument that legal regulation of assessment-type information is difficult both because it's difficult to identify specific investors with an

inclusively, chilling outsider trading that does not substantially hurt traded firms or their uninformed investors.<sup>272</sup> Accordingly, we suspect that only a small proportion of traded firms would opt for such an informational scope to their trading restrictions.

We can imagine, however, that particular types of firms would wish to adopt analogs to Rule 14e-3's prohibition of trading based on tender offer information. Firms, for example, may wish to prohibit trading based on classes of information that might have large discrete impacts on a firm's stock price. Biotech firms, for example, might restrict outsider trading based on nonpublic patent information. Military suppliers might restrict outsider trading based on nonpublic information about large procurement contracts. Mass tort defendants might prohibit outsider trading based on nonpublic information concerning litigation. While it is reasonable to worry that a catchall restriction on trading based on material information would be unworkable, the experience with Rule 14e-3 suggests that prohibiting outsider trading based on tender offer information need not have an undue chilling effect on the traded firms' liquidity. We suggest that the opt out menu provide options for firms to restrict trading on the bases of these additional categories of information as well as others that have been shown to have statistically significant effects on share price through abnormal returns event studies.<sup>273</sup> Indeed, where regulators have fears that traded firms may unduly interfere with overall information pro-

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assessment advantage and because "information assessments have a strong subjective element, it would be difficult to prove that an investor materially misstated her assessment of the information." *Id.*

*See also* Carlton & Fischel, *supra* note 111, at 886-87 (stating that "[k]nowledge that one of the firm's top managers is dispirited because of family problems or because preliminary reports on a new technological process show that costs are running much higher than expected are examples of valuable information that is almost surely not material in a legal sense. As long as insiders are allowed to own and trade shares, therefore, Rule 10b-5 is likely to have a minimal deterrent effect on most of the insiders' desired trading activities." (citations omitted)); Fried, *supra* note 70, at 335-37 (contending that insiders enjoy the ability to profit from trades on "sub-material" nonpublic information).

272. *Cf.* Kahan, *supra* note 56, at 990 (recognizing that requiring the disclosure of "assessment" type information may result in too much disclosure, resulting in "excessive disclosures of useless information assessments at a substantial compliance cost").

273. *See, e.g.,* Gregg Jarrell & Sam Peltzman, *The Impact of Product Recalls on the Wealth of Sellers*, 93 J. POL. ECON. 512, 513 (1985); Changqi Wu & John K.C. Wei, *Cooperative R & D and the Value of the Firm*, 13 REV. INDUS. ORG. 425, 425 (1998); Zaher Z. Zantout & George P. Tsetsekos, *The Wealth Effects of Announcements of R & D Expenditure Increases*, 17 J. FIN. RES. 205, 205 (1994); *see also* Stephen P. Ferris et al., *The Response of Competitors to Announcements of Bankruptcy: An Empirical Examination of Contagion and Competitive Effects*, 3 J. CORP. FIN. 367, 367 (1997); Gun-Ho Joh & Chi-Wen Jevons Lee, *Stock Price Response to Accounting Information in Oligopoly*, 65 J. BUS. 451, 471 (1992); Larry H.P. Lang & René M. Stulz, *Contagion and Competitive Intra-Industry Effects of Bankruptcy Announcements: An Empirical Analysis*, 32 J. FIN. ECON. 45 (1992). The possibility that outsider information may have a statistically significant impact on share price as demonstrated in the above event studies is discussed in Ayres & Bankman, *supra* note 9, at 241-47.

duction in the secondary market, regulators may take a more staged approach toward internalization and provide firms with the ability *only* to opt-into Rule 14e-3 type prohibition for certain defined classes of information.<sup>274</sup> Conversely, where regulators fear that managers may use the ability to control outsider trading to quash trades based on negative information on the managers' own performance, regulators may wish to exclude classes of information related to managerial malfeasance explicitly from the control of traded firms.<sup>275</sup>

As to the types of traders, we would allow traded firms to have the restrictions apply to all outside traders (and indeed if there is a strong-form imperative for information parity, this might be required).<sup>276</sup> But if there is only a weak-form imperative for informational parity, the opt out menu might make the outsider trading restrictions not market wide, allowing firms instead to restrict the informed outsider trading of particular firms or individuals. We would also allow traded firms to place informed trading restrictions on particular types of firms or individuals. Jonathan Macey and his coauthor have persuasively argued that there may be a predictable set of outsiders who can be probabilistically expected to learn about nonpublic information concerning particular companies before other outsiders.<sup>277</sup> In particular, it is reasonable for a firm to impose trading restrictions on major customers, suppliers, or coventurers who might easily come to possess nonpublic information that creates informed trading opportunities in another firm. While such trading could be controlled under the misappropriation doctrine if the traded firm expressly or implicitly contracts for trading abstinence by other firms that are already in privity, it might facilitate the internalization process to allow traded firms to impose unilaterally such restrictions (by filing the appropriate notification documents with the SEC) and put the burden on the potential trader to bargain for the freedom to engage in informed trading.

More importantly, there are a host of related firms — including rivals and the producers of complementary products — that may not have a preexisting contractual relationship with traded firm. It is reasonable for traded firms to restrict informed trading by these non-

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274. For a discussion of the problem of third-party information externalities, see *supra* Section IV.A.1.

275. See *supra* Section IV.A.2.

276. See *supra* note 17 (describing the parity-of-information approach to insider trading liability).

277. See Haddock & Macey, *supra* note 96, at 1463 (contending that market professionals may be better situated compared with other outside investors to learn about and profit from company-specific information once insiders are forbidden from trading). These so-called "palace guards" are not inside the tsar's court but just outside and hence well-placed to be the first external source for information about the inner sanctum. See Ayres, *supra* note 227, at 992-95 (describing market specialists as "palace guards" able to learn about material information related to a corporation prior to other outside investors).

privity market participants. Ayres and Bankman, for example, show how a firm may have perverse incentives to engage in informed trading against its rivals: informed trading of this kind is likely to raise a rival's cost of raising capital by raising the bid-ask spread on the rival's stock and systematically visiting trading losses on the rival's shareholders.<sup>278</sup> They propose an algorithm for identifying the set of related firms that are particularly likely to obtain informed trading opportunities on the stock of a particular firm.<sup>279</sup> It is reasonable for regulators to delegate to the traded firms the ability to restrict substitute insider trading by such related firms.

Several alternatives exist, as well, to provide a mechanism to enforce a particular level of informed trading. It might at first seem that the only type of trading restriction would be the "abstain or disclose" rule, under which an informed trader would have to abstain from trading or publicly disclose the nonpublic information prior to trading. But it turns out that both more and less stringent alternatives are also plausible and hence should be offered as menu alternatives. For example, firms might impose an unconditional abstention rule, meaning that you must refrain from trading based on particular types of nonpublic information even if you have previously disclosed it to the market. Some traded firms might opt for this more inclusive restriction because they would not want to give the informed trader the opportunity of trading on ineffectively disclosed information or using the threat of public disclosure followed by trading as a means of extorting hush money from the traded corporation. Texas Gulf Sulphur might have been willing to pay hush money to an informed outsider trader who was about to disclose as a precursor to trading.<sup>280</sup> A traded firm in such circumstances might prefer a blanket trading ban.

While remaining somewhat agnostic as to the exact mix of alternatives that traded firms would opt for, however, we think it is likely that firms would be more attracted to delayed-trading requirements. Delayed-trading rules are procedural and ministerial restrictions that turn less on the quality of material disclosure and more on verifiable factors such as the passage of time, the identity of the proposed trader and the size and price of the intended trade. Such a rule, imposing a blanket delay on all trades, is less vulnerable to the uncertainties of determining what is material as well as the difficulties private parties may face in detecting specific improper trades.<sup>281</sup>

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278. See Ayres & Bankman, *supra* note 9, at 266.

279. See *id.* at 287.

280. See *supra* note 230 (discussing the facts of *Texas Gulf Sulphur*).

281. Cf. Frank H. Easterbrook, *Insider Trading as an Agency Problem*, in PRINCIPALS AND AGENTS: THE STRUCTURE OF BUSINESS 81, 90-97 (John W. Pratt & Richard J. Zeckhauser eds., 1985) (noting the difficulties contracting parties face in detecting improper trades).

In the context of insider trading, Jesse Fried proposed a pre-trading disclosure rule of this kind for insiders, forcing insiders to disclose their identity and intended trades shortly before they execute their trades.<sup>282</sup> Pre-trading disclosure of insider trading intentions provides the market with information useful in deciphering the informational content of the trades. Where an insider, for example, makes an unusually large sell order to the market, the market may infer for example that the insider has nonpublic material negative information related to the insider's own company value.

A menu alternative that allowed traded firms to force disclosure about a large volume outsider trade, including the identity of the trader, the amount, perhaps the bid or ask price at which the trader was offering to trade, and the historical performance of the trader would enable other market participants to decode the information.<sup>283</sup> The market reaction to disclosure is then likely to decrease the trader's ability to benefit from an information advantage. Such traders will face a far reduced ex ante incentive to engage in information research.<sup>284</sup> Giving the traded firm the ability to require pretrade disclosure of these kinds of decoding information (price, quantity, and identity) provides the traded firm the effective ability to restrict outsiders from engaging in informed trades. We would also allow traded firms to require that large volume outsider traders report their motivation for the trade.<sup>285</sup> Disclosure of motive and business purpose has been required in a variety of other corporate contexts.<sup>286</sup> But again, the

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282. See Fried, *supra* note 70, at 348-64. Fried notes that: "Corporate insiders should not, in principle, be able to consistently outperform public shareholders if public shareholders are given the ability to perform the exact same trades as insiders." *Id.* at 350.

283. Other market participants, for example, may pay close attention particularly to a trader with a historical track record of high returns from her trades. See *id.* at 354-57 (describing how market participants may react to the trading history of an insider trader subject to a pretrading disclosure rule to eliminate the excess returns from insider trading).

284. Where the market is on average correct in its decoding of the trade signal, informed traders will not earn superior returns where they are unable to cancel their trade order. For example, consider Trader X with nonpublic information that Texon is really worth \$80 when the market values Texon at \$50. Trader X may then attempt to initiate a large purchase order for a certain amount of shares at the market price. The market may then either overreact, raising the price to \$90 per share or under-react, raising the price to \$70 per share. On an expected basis, to the extent Trader X cannot reverse its trade request, Trader X will expect to purchase the shares at \$80 per share. As an alternative, regulators may allow traders to cancel their trade order after revealing their identity and intentions. Under such a situation, regulators may impose a monetary fine on Trader X to reduce the possibility of Trader X gaining superior returns. See, e.g., Fried, *supra* note 70, at 351.

285. It is controversial whether such requirements induce effective disclosure of material information or whether they are merely an invitation for nuisance litigation. We are agnostic as to whether firms would find it useful to require this more far-reaching disclosure as a prerequisite for large volume trading.

286. For example, the Williams Act requires the owner of more than five percent of a class of a firm's equity securities to make a Schedule 13D filing with the SEC containing information disclosure required under Section 13(d) of the Williams Act and the SEC's own

traded firm internalizes the primary costs of adopting an overly broad restriction that chills its shareholders' liquidity and it, instead of us or the SEC, is best placed to make this decision.

Presently in the public capital markets, an investor seeking to transact in securities may do so in one of several ways. Investors execute either sell or buy transactions through the submission of a market order or a limit order with their broker. Investors typically submit a market order through a broker, agreeing to transact at the prevailing market price. Brokers handling the order then come under a duty to ensure that the investors' orders are executed at the best possible price.<sup>287</sup> Investors who place a limit order, on the other hand, specify a fixed quantity of shares that they are willing to either purchase or sell at a set price.<sup>288</sup> Certain larger market participants may function as market makers, holding out simultaneous bid and offer limit prices to the market. Other more sophisticated market participants may seek to negotiate directly with one another, bypassing market makers and possibly obtaining a price in between the national best bid and offer prices.<sup>289</sup>

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rules and regulations. *See* Williams Act § 13(d)(1), codified at 15 U.S.C. § 78m(d)(1) (2000). Among the required disclosure items include the identity of the owner, the source and amount of the funds used to make the purchase, and any plans the owner may have to liquidate, merge, or make a major change to the corporation if the purpose of the owner is to acquire control. *See id.* Corporations that seek to merge as well as an acquirer engaged in a tender offer must make a premerger notification to the Justice Department. *See supra* note 189.

287. Broker's are under a duty of best execution. Although the SEC lacks a formal rule relating to the duty of best execution, various sources of law provide support for the duty. The National Association of Securities Dealers Regulation Inc., for example, has also established interpretive guidance on the duty for its member brokers. Article III, Section 1 of the NASD Rules of Fair Practice provides that member brokers and associated persons must "use reasonable diligence to ascertain the best inter-dealer market for the subject security and buy or sell in such market so that the resultant price to the customer is as favorable as possible under prevailing market conditions." NASD Manual (CCH), Rule 2320(a); *see also* NYSE Rule 123A, 2 N.Y.S.E. Guide (CCH) P 2123A.41, at 2748 (adopted June 19, 1969); AMEX Rule 156(a), 2 Am. Stock Ex. Guide (CCH) P 9296, at 2467-3 (adopted May 13, 1965). The SEC's position traditionally has been to treat brokers that execute transactions at the national best bid or offer price quoted on NASDAQ as meeting their duty of best execution. *See, e.g.,* DIVISION OF MARKET REGULATION, MARKET 2000: AN EXAMINATION OF CURRENT EQUITY MARKET DEVELOPMENTS (Jan. 1990). Nevertheless, the emergence of electronic communications networks ("ECN") offering potentially better prices for investors has led the SEC to require brokers, under certain circumstances, to also consider the ECN's bid and offer prices. *See, e.g.,* Order Execution Obligations, Exchange Act Release. No. 34-37619 (Aug. 29, 1996).

288. *See* Request for Comment on Issues Relating to Market Fragmentation, Exchange Act Release No. 34-42450, 71 SEC Docket 1702, at 1707 (Feb. 23, 2000); *see also* *About NASDAQ*, at [http://www.nasdaq.com/about/about\\_nasdaq\\_long.stm](http://www.nasdaq.com/about/about_nasdaq_long.stm) (describing various methods of executing a trade on NASDAQ) (last visited Oct. 17, 2002).

289. Institutional investors may use NASDAQ's Selectnet system, for example, to communicate with one another and negotiate a trade at a price in between the national best bid and offer prices. For information on Selectnet, *see* *About Nasdaq*, at [http://www.nasdaq.com/about/about\\_nasdaq\\_long.stm](http://www.nasdaq.com/about/about_nasdaq_long.stm) (describing the Selectnet system) (last visited Oct. 17, 2002).



The menu would also allow the traded firm to choose the length of the trading delay. Consider a one-hour delayed-trading rule.<sup>290</sup> Under the one-hour delay, all traders must publicly announce the terms of prospective trade orders one hour before executing the order.<sup>291</sup> In the case of a limit order, the traders must also announce the limit price they plan to establish.<sup>292</sup> Predictably, the delayed-trading rule would then have adverse consequences on investors seeking to trade securities. Under the delayed-trading rule, investors seeking to engage in a market order trade face a delay of one hour from the time they make their pretrade announcement to the time when their market order would be allowed to execute in the market. Investors seeking to engage in a limit order trade face even larger risks. Such investors bear not only the risk that the market may move against them during the one hour period but also are required to use only the announced pretrade limit price.

The cost of the delayed-trading rule, nonetheless, is greater for traders seeking to trade on an information advantage. Whether submitting a market or limit order, investors with an information advantage run the risk that their advantage may dissipate during the one-hour delay. Indeed, for larger volume trades, the investors' own pretrade announcements may trigger a market price reaction.<sup>293</sup> Investors seeking to make a negotiated transaction between the national best bid-offer price typically trade in larger volumes than retail investors. The forced pretrade disclosure rule would then result in a corre-

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290. The choice of a one-hour delay is completely arbitrary. In the context of an insider pretrading rule, Jesse Fried provides a discussion of the relative merits of different length delays. See Fried, *supra* note 70, at 386-90.

291. Disclosure, of course, must occur in a manner designed to reduce the trader's information advantage to be effective. The effectiveness of disclosure, in turn, may be measured along at least two dimensions — the type of information and the manner of disclosure. Along each dimension, in turn, a variety of possibilities exist. Rather than specify any particular method, regulators may simply provide companies a menu from which to select various effective disclosure mechanisms. For example, one choice might be to have traders disclose the amount and price of their intended trades and then route this information to a centralized information source, including either a national securities exchange or the section. In the alternative, a company could have information on trades routed to itself.

292. Regulators may then either force traders to commit to their announced trade or allow traders to withdraw their order prior to the end of the one-hour delay. Where traders may withdraw their orders, regulators should deny traders the ability to make simultaneous bid and offer quotes. Without such a limitation, investors would be able to mask their trading intentions. For example, an investor seeking to sell a large volume of securities could simply submit simultaneous purchase and sell orders. Then at the end of the hour, the investor could withdraw the purchase order, allowing the sell order to execute in the market.

293. Market participants may have some problems decoding the informational content of an announced outsider trade. Nevertheless, given information on the identity, timing, and potential bid or ask price of a trade, market participants should have the ability to decipher significant information from larger block trades. See Alan Kraus & Hans R. Stoll, *Price Impacts of Block Trading on the New York Stock Exchange*, 27 J. FIN. 569, 574-78 (1972) (reporting strong price movements in the day following large block trades).

spondingly larger market reaction against the interests of the investors initiating such a negotiated transaction.

Liquidity traders, in comparison, face fewer costs from the delayed-trading rule. On the one hand, the market price may move against the investor; on the other hand, the market price may move in the investor's favor. On average, the liquidity trader will receive the same amount with or without a delay rule in place. Liquidity traders of course face the cost of delaying for one hour. For investors who need cash immediately, such costs may be non-negligible. Risk-averse liquidity traders also bear additional risk from the delayed-trading rule. To the extent that price movements during the one-hour delay are random, however, a diversified liquidity trader seeking to sell a portion of her entire portfolio will face only a minimal risk during the delay.

Moreover, the opt-out menu would give the traded firm the option of exempting small traders from delayed-trading concerns. To the extent most smaller investors lack any appreciable information advantage, the delayed-trading rule may be tailored to focus specifically on investors where the risk of informed trading is highest. Investors with a strong information advantage, in particular, typically seek to profit by trading large volumes of securities. The extent of an investor's profit from an information advantage is directly proportional to the amount of securities traded based on the information. We imagine that most firms would only require that firms be subject to trading a substantial number of shares in a short time period to be subject to the delayed-trading restriction.<sup>294</sup> Trades under 10,000 shares in volume, for example, are likely to be exempt under the restrictions adopted by traded firms, leaving the vast bulk of uniformed, liquidity trades unaffected.<sup>295</sup> Firms with different average daily trading volumes and varying types of investors (including liquidity traders with a large need to trade immediately), of course, could adjust (within perhaps a range of set menu options) the non-delayed-trading volume ceiling. On the other hand, some traded firms may wish to block even traders engaging in small volume trades. To the extent many small-volume investors trade based on noise and not material information, increasing trading

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294. Note that in 1998, block trades — defined as trades over 10,000 shares — accounted for 48.7 percent of the New York Stock Exchange's reported volume. See N.Y. STOCK EXCHANGE, FACT BOOK FOR THE YEAR 1998, at 16, 93 (1999).

295. See Judith Burns, *Deals & Deal Makers: Nasdaq's Conversion to Quoting Stocks In Decimals May Cost Up to \$130 Million*, WALL ST. J., May 26, 2000, at C16 (reporting that the average transaction volume on NASDAQ is only 625 shares). Although relatively small in number, large block trades account for a significant fraction of the total volume of securities trades. See Greg Ip, *Individuals' Role in Stock Market Grows As the Influence of Institutions Declines*, WALL ST. J., Nov. 16, 1998, at C1 (noting that block trades involving 10,000 or more shares accounted for just under 49% of the trade volume in the New York Stock Exchange for 1998).

barriers for the investors may actually result in an increase in overall securities price accuracy while also reducing expenditures undertaken as part of such noise trading.<sup>296</sup>

The ability of the delayed-trading rule to siphon profits from informed investors depends on other active investors in the market interpreting and using pretrade disclosures to execute trades ahead of the disclosing party. To the extent no single investor chooses to purchase the right to engage in immediate trades, however, an informed investor may nevertheless benefit from its information advantage through even delayed trades. Nevertheless, where even one investor chooses to purchase the right to engage in non-delayed trades, an informed investor's ability to benefit from delayed informed trades is much reduced. In the case where an outsider trader has purchased the right to engage in immediate trades and also engages in information research, the outsider trader will be able to profit fully from her information advantage before the first trades of other informed traders (without the right) even reach the market due to the trading delay. The presence of an outsider trader with the right to engage in immediate trades crowds out the ability of delayed traders from gaining a profit due to their information advantage.

The delayed-trading rule may nevertheless fail to block the ability of informed investors to profit where the traders obtain their information from an exclusive source of information. Particular investors, for example, may enjoy a specialized ability to value companies. Warren Buffett enjoys a well-deserved reputation for finding undervalued companies.<sup>297</sup> Because no other investor has the same information that Buffett generates, no direct competing investors exist to step in front of Buffett to take all the trading profits. On the other hand, to the extent such unique investors are well known and the trade is large enough in size, the market price may nevertheless react to the pretrade announcement of their intended transactions.<sup>298</sup>

The delayed-trading rule may also hinder market makers from either taking order flow or revealing their intentions to trade. Market makers on NASDAQ, for example, presently submit simultaneous bid and offer prices. Traders may then use NASDAQ's network to view the range of different bid and offer prices as well as desired share amount across all market makers and alternative trading systems con-

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296. So-called noise traders may cause large deviations of market prices from the fundamental value of a security and thereby increase market risk. See J. Bradford De Long et al., *Noise Trader Risk in Financial Markets*, 98 J. POL. ECON. 703, 703 (1990) ("The unpredictability of noise traders' beliefs creates a risk in the price of the asset that deters rational arbitrageurs from aggressively betting against them.").

297. See *supra* note 52 (citing newspaper reports lauding Warren Buffett).

298. See *supra* note 293 (citing evidence that large block trades result in significant stock market price movements).

nected to NASDAQ.<sup>299</sup> Because market makers are frequently buying and purchasing securities, they will run into the limits imposed through the delayed-trading rule. At the very least, the risks imposed through the one-hour delay will result in larger bid-ask spreads, to the detriment of all investors trading in the traded firm's stock.<sup>300</sup>

The drop in liquidity of the traded firm from a restrictive information research policy, however, is also internalized within the traded firm.<sup>301</sup> Investors who expect a relatively illiquid market will demand a higher discount when they initially purchase their shares for the additional delay in their ability to sell shares. Working backwards, investors purchasing shares initially from an issuer will demand a similarly large discount for the illiquidity risk. The traded firm (taking into account the other impacts from information research) therefore will have an incentive to adopt an information research policy that maximizes the liquidity of the secondary market for its securities.<sup>302</sup> Regulators may assist traded companies in dealing specifically with market makers through a program to register such market makers, including all parties that are in the business of continuously providing simultaneous bid and ask quotations.<sup>303</sup> We imagine that traded firms would ubiquitously exempt identified market makers from the delayed-trading restriction.

Lastly, the SEC may allow for a number of different sanctions provided through a menu of opt out alternatives that penalize outsider traders that fail to follow a firm's given informed trading restrictions. We can imagine giving the traded firm the option of specifying whether informed trading violations create a private right of action for the traded firm or its shareholders. The menu might also give traded firms the ability to grant the SEC the authority to investigate and to

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299. For example, using the Nasdaq Workstation II software, investors may query of Market Maker quotations, enter orders and trade reports through their computer terminals. For a description of the Nasdaq Workstation II, see <http://www.nasdaqtrader.com> (last visited July 14, 2001).

300. See Macey & Kanda, *supra* note 223, at 1012-14 (discussing the value of liquidity to investors).

301. See Yakov Amihud & Haim Mendelson, *A New Approach to the Regulation of Trading Across Securities Markets*, 71 N.Y.U. L. REV. 1411 (1996) (arguing that issuers internalize the benefits of increased liquidity for their own investors and therefore proposing to give issuers the exclusive ability to control the location where their trades will take place).

302. Texon, nevertheless, may ignore externalities that result from allowing informed outsider trading. We, nevertheless, make the argument in Section IV.A.1 that the magnitude of such externalities is small.

303. For example, the National Association of Securities Dealers ("NASD") already provides for a system to register market makers in securities that trade on NASDAQ. See NASD Manual (CCH), Rule 4611 (providing that information on quotations and quote sizes may be transmitted through NASDAQ only by a NASD "member registered as a NASDAQ market maker or other entity approved by [NASD] to function in a market-making capacity").

bring civil or criminal action against violators of informed trading restrictions (with sanctions up to the same level available for insider trading violations).<sup>304</sup> Of course, it at first seems unusual to allow a private firm to decide the ambit of the criminal law.<sup>305</sup> But the misappropriation doctrine does just this with regard to a source's ability to criminalize informed trading by its agents. The SEC might charge a traded firm fees to cover the government's marginal (expected) cost of enforcement — so as to force the traded firms to internalize the full costs of exercising their property right.<sup>306</sup>

#### 4. Summary

Internalization brings the possibility that the market may work to determine the optimal level of information research with respect to outsider trading. Henry Manne's insight with respect to insider trading in combination with this Article's proposal allows for a laissez faire approach to outsider trading. Shifting the property right to engage in informed trades to the traded firm permits the implementation of relatively low-cost transactions with potential informed traders. The reduction in transaction costs, in turn, allows for Coasean bargains among the informed traders and the traded firm. To the extent most of the costs and benefits from informed trading are internalized, the bargains struck will approximate the first-best information research outcome.

Internalized outsider trading, in fact, may prove a more fruitful area for self-regulation than insider trading. Unlike insider trading, internalization involving outsider trading is relatively free of the problem of opportunism. Although the traded firm may directly internalize

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304. In addition to possible criminal fines and imprisonment as well as civil injunctive relief and the disgorgement of profits, insiders may also face heightened civil penalties for insider trading. In 1984, Congress enacted the Insider Trading Sanctions Act, providing for a possible civil penalty for insider trading up to "three times the profit gained or loss avoided" from the insider trading. Pub. L. No. 98-376 § 2, 98 Stat. 1264, 1264 (1984) (codified at 15 U.S.C. § 78u(d)(2)(A) (Supp. III 1985)). Insiders must pay the penalty directly to the Treasury of the United States. *See id.* In 1988, Congress enacted the Insider Trading and Securities Fraud Enforcement Act of 1988, Pub. L. No. 100-704, 102 Stat. 4677 (1988), giving the SEC the power to seek civil penalties of up to \$1 million and increasing criminal fines to \$1 million as well as prison time for insider trading to 10 years from 5 years. *See id.* The Insider Trading and Securities Fraud Enforcement Act also established a bounty system that gives up to 10% of the assessed penalty to informants. *See id.* *See generally* LARRY E. RIBSTEIN & PETER V. LETSOU, BUSINESS ASSOCIATIONS § 13.08, at 994 (3d ed. 1996) (summarizing the provisions of the Insider Trading and Securities Fraud Enforcement Act).

305. One of us, nevertheless, has made the argument that firms should have a limited ability to self-tailor the regulatory regime surrounding its securities. *See Choi, supra* note 259, at 951-58

306. However, we should keep in mind that we do not generally charge fees for protecting other property rights and to do so would often be deemed to produce an inefficient distortion in the creation of property.

many of the impacts from insider trading, insiders may force the traded firm to allow insider trading even when against the best interests of the traded firm's shareholders. Insiders at the traded firm, on the other hand, have fewer incentives to make decisions opportunistically regarding outsider trading. Whereas insider trading directly increases the wealth of insiders, informed outsider trading only generates increased fees for the traded firm directly. Without some side-payment from the outsider trader to management, insiders will have no different incentive with respect to outsider traders than with any decision that may increase the traded firm's overall profits.<sup>307</sup>

### C. Implementation Problems

Several possible implementation problems exist with the Article's internalization proposal. First, the ability of companies to commit to a particular informed trading policy is important to implementation. In deciding how much to pay initially for a traded firm's securities, investors will take into account the number of informed trades that will occur in secondary market trading. Where the traded firm may later change its information research policy, investors will fear that the traded firm may not act in their best interest.<sup>308</sup> Investors, for example, may desire an all-may-research policy. As a result, the traded firm may adopt such a policy. After the initial sale of securities, the traded firm may then change its policy, selling the right to engage in informed trades for a high price to a limited number of investors. Investors fearful of a subsequent policy shift will demand a higher discount at the time of the initial offering. The traded firm then benefits from committing to a particular information research policy.

Regulators, in turn, may assist companies in committing to a particular information policy. Some companies, for example, may wish to adopt a particular information policy and then "freeze" the policy. Part of the opt out procedures should also allow traded firms to commit to various degrees of constraints on the ability of future amendments to the information policy. Traded firms might make a particular policy subject to amendments only based on a super majority vote of shareholders and/or the board or impose a large monetary penalty for regime changes. Again, firms are well placed to decide whether retaining the flexibility of adjusting their informational policy in the future is to their benefit. A traded firm has good incentives to select a procedural mechanism that balances both the value of flexibility

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307. We discuss the problem of managerial self-dealing in the context of outsider trading *supra* Section IV.A.2.

308. Cf. Gordon, *supra* note 182, at 1573 (arguing that "[o]ppportunistic amendment is possible because the corporate contract is inevitably incomplete. The parties cannot specify terms to cover even plausible contingencies").

against the need of shareholders to protect against future managerial opportunism.

Second, not all market participants that engage in information research do so to engage directly in trades. Analysts, for example, may conduct research to generate information for resale to a large number of investors. To the extent a traded firm opts for a minimum trade threshold before the delayed-trading rule takes effect, analysts may still benefit from the sale of information to small volume investors. Regulators, nevertheless, may prohibit the sale of information relating to a specific company on the part of analysts. Alternatively, regulators may allow traded firms to determine whether to allow specific analysts to sell information to others, allowing the traded firm to charge a fee for such a privilege.

Third, even an investor who otherwise would engage in information research and then engage in large volume trades may potentially avoid the delayed trade rule through a series of smaller trades. Indeed, large block traders already have an incentive to hide their trading intention through smaller trades to avoid a negative market reaction that may increase the cost of their trade. Regulators, nevertheless, may respond to the risk of partitioned trades in a number of ways. To the extent the minimum trade threshold for the delayed-trading rule is sufficiently low, large block traders may simply find it infeasible to partition their trades into small enough lots to satisfy the requirement. To the extent the minimum trade threshold is set at 10,000 shares, a block trader seeking to sell one million shares, for example, will have to submit 100 separate offers to sell through different identities in an attempt to avoid detection.<sup>309</sup> The large number of separate 10,000 share offers makes it unlikely that the trader will succeed at hiding its trades from either the market or regulators. Regulators may also install rules designed to allow market participants and regulators to trace quickly the true transacting parties.<sup>310</sup> Such rules, in turn, will limit the ability of an investor hiding their identities and trades through "front" investors.

Finally, certain sources of information relevant to the valuation of a traded company's securities may not seek to negotiate for the right

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309. Alternatively, investors seeking to engage in a large block trade may go offshore to escape the delayed-trading rule. See Amihud & Mendelson, *supra* note 301, at 1438 (stating that "[i]nvestors who want to hide information will execute their block trades in markets with lenient reporting requirements, free riding on those who trade in an exchange that provides prompt trade reports. The order flow into the market that enforces trade reporting rules may also decline, further reducing liquidity."). The cost of such block trades, however, are borne at least initially by uninformed investors in the offshore markets and not investors within the United States.

310. Here again the SEC could assist through the establishment of a centralized database interfaced with the databases of broker-dealers to trace the ownership of securities held in street name.

to engage in informed trades even where such trades are profitable. Nevertheless, such circumstances are often not problematic because most sources that choose not to negotiate will not be directly concerned with trading profits. Put another way, many sources will generate information even without the possibility of trading profits and will continue to do so even if they do not bid to engage in informed trading.<sup>311</sup> For example, government regulators, newspapers, and competitors of a traded company all may generate specific information relevant to the traded company's securities pricing even without the prospect of trades in the securities. Instead, mainly securities markets professionals — who expend resources collecting information from many different sources and analyzing the information — might alter their information research activities based on their ability to trade upon such information.

## V. CONCLUSION

The securities laws of the United States make regulatory distinctions based on the source of an information advantage and the presence of a fiduciary duty. Insiders that trade based on nonpublic material information obtained from the traded firm, for example, face classical insider trading prohibitions. Even outsider traders that obtain their information through a breach of fiduciary duty may face potential liability under the misappropriation theory of insider trading. Rule 14e-3 restricts the ability of outside investors to trade based on tender offer-related information. Regulation FD, similarly, prohibits firms from providing nonpublic, material information to outsiders selectively. Aside from such prohibitions, however, the securities laws provide no limitations on information research, implicitly giving outsider traders a right to engage in informed trades.<sup>312</sup>

Despite the present laws' focus on the source of information, this Article has argued that any form of informational disparity in the capital markets can be usefully assessed from a common informational effects framework. If regulators were the final arbiters of whether particular classes of informed trading are to be permitted, the framework could very well provide justification for some of the present prohibitions against the use of information in securities transactions. For example, insider trading by employees may result in a net social loss in many instances. The framework may also demonstrate that outsider trading is beneficial for investors in many circumstances. Regulators

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311. See *supra* note 85 and accompanying text (discussing “non-trading” information).

312. But see *supra* note 101 (describing other more specific limitations to outsider trading).



might apply the framework's normative analysis directly to determine what information advantages to allow in the market.

The Article, nevertheless, takes a different approach. Rather than recommend particular divisions between allowable and prohibited information advantages, the Article argues that regulators should instead focus on enabling the market to make such determinations. In particular, regulators may help the traded firm internalize the various effects of an information advantage. Granting the traded firm a right to control outsider informed trades in the traded firm's own securities allows the traded firm to indirectly control information research related to its securities. Regulators may then establish low-cost mechanisms for investors to negotiate with the traded firm to purchase the right to engage in informed trades. When both the informed trader and the traded firm believe that informed trading will be privately beneficial, there are strong reasons to believe that the informed trading will promote social welfare more generally.

Internalization via such contracts, of course, is not perfect. Others have identified possible externalities that internalization may fail to capture. For example, under the Article's internalization system, the traded firm may ignore the external benefit information research has for the overall cost of research at other companies. But many of these residual externalities are only small in magnitude or could be captured more efficiently by mandating disclosure by the traded firm itself. Moreover, there are many classes of informed outsider trading that predictably produce minor and ephemeral external benefits, such as frontrunning information that would be shortly disclosed to the market in the absence of outsider trading. Traded firms should at least be given the right to curtail such frontrunning. And no one who supports Rule 14e-3 can take the position that the external benefits of informed outsider trading always outweigh its costs. No one system will achieve the first-best level of securities research where external effects exist. The Article's internalization system (with appropriate limits on traded firms' control to account for potential third-party benefits), nevertheless, achieves a very close second best, taking into account the majority of impacts from informational research.

Henry Manne long ago realized that employment contracts allowed firms to internalize the costs and benefits of their employees' informed trading, but failed to see from this internalization perspective that outsider trading (by, say, stock analysts or rival firms) was more problematic. Because informed trading by outsiders does not currently need to garner the consent of the traded firm, we should be less confident that it enhances social welfare. From an internalization perspective, the current regulatory emphasis on insider as opposed to outsider trading gets it exactly backward. Manne, as a noted libertar-

ian,<sup>313</sup> may have shied away from raising this point for fear that regulators would ham-fistedly prohibit large classes of outsider trading. But we have shown that a concern with the efficiency of outsider trading does not necessitate a restriction on freedom of contract. Our proposed system of allowing traded firms to restrict informed trading in their shares is still a laissez faire regime, but one which has reassigned from the outside source to the traded firm an alienable right to control whether informed trading takes place.

Several variants of the precise right that traded firms may allocate to parties to engage in informed trading are possible. At the very least, we have argued that traded firms should have the ability to expand the scope of Rule 14e-3 blanket trading prohibitions to include other classes of information in addition to tender offer related news (with the possible exception of negative manager-related information). Under this minimalist proposal, the traded firm could adopt an across-the-board Rule 14e-3-like prohibition against informed trading on the basis of nonpublic patent information, but would be prohibited from selectively selling rights to trade on the basis of such information. If compared to the current regime, this proposal should be deeply attractive to a variety of academics. Libertarians will be hard put to criticize a proposal that grants more contractual liberty to traded firms, and left-leaning thinkers should embrace potentially broader restrictions on informed trading. Cast in terms of the efficient capital markets hypothesis, we can now see that allowing outsider traders to push a particular firm's stock toward "strong form" efficiency — where even nonpublic information is impacted into the current stock price — may be both socially inefficient and expose the traded firm shareholders to uncompensated costs.<sup>314</sup> A traded firm should (and would under our minimalist proposal) have the right to decide that it wishes its stock to be efficient in only the "semistrong form" sense, so that only public information would be impacted into its stock price.<sup>315</sup>

A more ambitious version of our internalization proposal — which would allow the traded firm to alienate selectively its informed outsider trading rights — is likely to be more controversial. Once the beneficial effects of giving traded firms control over the scope of Rule 14e-3 are recognized, regulators may wish to consider a further expansion to allowing traded firms the ability to allocate the right to engage in informed trading selectively among outsider traders based on the identity of the trader. Some liberals would cringe at the prospect that

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313. For example, in a profile of Henry Manne, the *Washington Times* reported under the heading "self-portrait" that Manne was "[l]ibertarian, independent, intellectual." WASH. TIMES, Jan. 20, 1994, at C15.

314. See *supra* note 18 (defining the strong form of the efficient markets hypothesis).

315. See *supra* note 18 (defining the semistrong form of the efficient markets hypothesis).

outsiders would be able to purchase the right to take advantage of the uninformed side of the market. But advantage taking exists today — without the traded firm either consenting to or being compensated for the informed trading.

Moving outward along a continuum of choice (and controversy), regulators may finally consider giving traded firms the right to reduce the current scope of informed trading restrictions — e.g., limiting the reach of insider trading liability for a traded firm's own managers. The heightened possibility of managerial self-dealing, nevertheless, may caution regulators against such an expansion of choice with respect to insider trading in a way not applicable to outsider trading where managerial self-dealing is not as great a risk. Many people will not want to ride on the internalization train this far, but they should at least be willing to begin the journey.

In an analogous debate in the context of takeover law, Frank Easterbrook and Dan Fischel put forth the argument that during a tender offer, the management of a target firm should remain passive, not mounting any defensive tactics to block their shareholders from accepting the tender offer. Passivity would prevent managers from, among other things, assisting other outside bidders attempting to free ride on the informational investments of the initial tender offeror.<sup>316</sup> Their passivity thesis is in fact quite comparable to the so called “property rights” rationale for laissez faire outsider trading. Both theories attempt to preserve the incentives for outsiders to deliberately acquire outside information. However, Haddock, Macey, and McChesney's (“HMM's”) “passivity killer” article in the *Virginia Law Review*<sup>317</sup> demolished the passivity thesis (in a way that quickly caused Easterbrook and Fischel to recant).<sup>318</sup> HMM showed that giving the target board the ability to resist a hostile tender offer may increase the welfare of the target company's shareholders along a number of dimensions. The ability to resist gives the target company more bargaining power and thereby a share of the takeover surplus, giving target firms themselves a greater ex ante incentive to search for value increasing business combinations.<sup>319</sup> Resistance may also give managers the needed reassurance to engage in firm-specific investments in human capital.<sup>320</sup>

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316. See Frank Easterbrook & Daniel Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161, 1175-77 (1981).

317. See David D. Haddock et al., *Property Rights in Assets and Resistance to Tender Offers*, 73 VA. L. REV. 701 (1987).

318. See FRANK H. EASTERBROOK & DANIEL R. FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 174 (1991) (accepting HMM's position that tender offer passivity should not be an immutable rule but rather a contractual default).

319. See Haddock et al., *supra* note 317, at 709.

320. See *id.* at 712-17.

Just as HMM demonstrated that the target companies (literally the traded firms in a tender offer) should have the alienable right to restrict hostile takeover activity (comparable to outsider trading), we have argued that traded firms should have the alienable right to restrict informed outsider trading in their firms. Indeed, our internalization argument is more straightforward than either Manne's powerful insider trading argument or HMM's forceful takeover argument because concerns with managerial self-dealing and entrenchment are much more attenuated with regard to the traded firm's decision to restrict or sell outsider trading rights (than with regard to a traded firm's decision to restrict or sell insider trading or takeover rights).

Viewed more generally, the Article's proposed internalization system represents a new approach to securities regulation. Market failures may certainly exist affecting all types of securities transactions. Up to now, the standard response to market failures has been one of mandatory regulation.<sup>321</sup> Internalization, however, provides regulators another option. Instead of determining from above how a market should operate, regulators should strive to connect parties through contract that otherwise would fail to negotiate with one another. Once connected, internalization will produce regulatory protections far more tailored to the needs of market participants than mandatory regulation from above.

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321. For an example of this standard approach, see Fox, *Retaining Mandatory Securities Disclosure*, *supra* note 171 (arguing that externalities and the possibility of manager opportunism requires the imposition of mandatory securities disclosure).